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Accounting News And Trends

Retained Earnings and Terminology

Is it necessary to disclose on the face of the balance sheet that the amount designated as "Earnings Retained in the Business" has been reduced by transfers to capital resulting from stock dividends, stock splits, restatement of capital stock account, etc., although such disclosure is not normally made when the designation "Earned Surplus" is used? *The Arthur Young Journal* (June 1957) reports that its Research Department found a wide variety of explanatory terms in current use.

The procedure recommended is to designate the balance of earnings retained in the business by the addition of an explanatory phrase such as "excluding amounts transferred to capital." The disclosure of the cumulative amount transferred to capital from earnings retained in the business is not considered essential although there is no objection to doing so.

Audit of Union Welfare Fund

The funds controlled by unions have been the subject of much recent comment and, therefore, J. Malcolm Colemen's short article on "Union Welfare Fund" (*The Connecticut CPA*, September 1957) is particularly appropriate. Of interest to accountants is his outline of certain of the audit procedures for a fund covering about 10,000 employees and 160 employers.

1. The fund is audited on a quarterly basis and, in addition to ordinary auditing procedures, confirmations are mailed to employers on a substantial test basis requesting verification of their remittances during the period under review.

2. In lieu of confirmation with individual employees, photostatic copies of all remittance reports are mailed to the business agents of the unions involved.

3. Additional audit checks are made to ascertain that the hours on the remittance reports are being properly credited to the individual employee.

4. The quarterly audit report includes a detailed list of the employers and the dollar amount of their remittance during the period. Because of the difficulty of determining the amount due from each employer at the statement date, receipts may be shown on either a cash basis or an estimated receivable basis, provided, however, that the method adopted is fully disclosed.

Fee Survey

A booklet entitled "Fee Survey" (August 1957) contains a statistical analysis of a questionnaire submitted to its members by the Colorado Society of CPAs. Its 22 pages contain a number of graphs and charts which analyze the available information in a variety of interesting ways. Some of the conclusions of the study are worthy of comment.

1. About 75% of the firms outside Denver plan to raise fees for both

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ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, C.P.A. *and member of the New York Bar. He is presently serving as chairman of our Society's Committee on Members in the Field of Education.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

existing and new clients while 55% of Denver firms plan to raise existing clients and 70% to raise new clients.

2. For all firms, regardless of size or location, gross fees from tax work constituted 25% of the total as compared with 19% for audits, and 20% for financial statements issued with a disclaimer of opinion.

3. Bookkeeping work represented over 20% of the gross fees for individual practitioners and medium-sized firms outside Denver.

4. In the larger Denver firms, however, audit work produced 38% of the total fees and tax work 21%.

Municipal Accounting

Accountants who perform municipal audits will be interested in two booklets published jointly by the League of California Cities and the California Society of CPAs. These are—"Check List for the Audit of the Financial Records of a California City" (March, 1956) and "Chart of Accounts for California Cities" (June, 1957).

The first booklet should enable the auditor to establish adequate auditing procedures. As its name indicates, it is a check list and not an audit program but the topics covered and steps outlined are a worthwhile guide. Some of the procedures listed would not apply in all cases and other audit steps not listed might be called for in particular circumstances. The auditor will select those steps and do whatever testing and sampling he deems appropriate in the particular situation to enable him to express an informed opinion on:

1. The fairness of financial statements.

2. The propriety of accounting principles involved.

3. The accountability of officers and employees.

4. Compliance with applicable laws.

The second booklet is designed to

bring about a greater degree of uniformity in the fiscal recordkeeping of California municipalities with a consequent improvement in financial administration. At present the charts of accounts used by many cities are too long and too complicated because they attempt to classify separately every possible type of expenditure. The recommended chart of accounts has been designed for all California cities but it is recognized that situations not covered may require special treatment.

The explanatory material preceding the listing of the accounts contains some general suggestions and the following discussion of how to handle certain types of expenditures is illustrative. A problem common to many cities is the proper recording of certain activities which are partially financed from special revenue funds as well as from the general fund. These expenditures should be recorded in the fund which provides the revenues. To facilitate budgeting, however, it is recommended that expenditures for a particular activity be recorded originally in the general fund, and that the portion financed by another fund be charged to the other fund with an offsetting reduction of the original expenditure in the general fund. For statement purposes the total expenditure for each activity should be shown in the general fund and a deduction should be made at the end of the expenditures statement for amounts charged to special revenue funds.

The CPA and Estate Planning

The fact that the CPA is an essential member of the estate planning team is emphasized in a leaflet distributed by the Trust Department, First National Bank, Jackson, Mississippi, and reprinted in *The Mississippi Certified Public Accountant* (Summer, 1957).

The leaflet points out that estate planning covers four specialized fields of activity and the planning team should consist of a lawyer, a life underwriter,

a trust officer and a CPA. The specialized knowledge of the CPA enables him to find out and correct financial problems of a going business as well as to advise on its proper future course. The CPA can assist in determining the value of any business in the estate and, working with the trust officer, can arrive at an estimate needed for various estate taxes. He is of material assistance both while plans are being formulated and during actual negotiations with the taxing authorities.

This is an excellent example of how bankers and accountants can engage in a joint public relations activity that informs the community of the services that each group is prepared to render.

Size of an Accountant's Practice: Credit Grantors' View

Bankers are vitally interested in the size of the accountant's practice when he submits a report to them on behalf of a borrowing client, according to Harold R. Jones, Vice President of the Bank of Texas, Houston, in his article "Professional Independence" (*Bulletin of the Robert Morris Associates*, August 1957). Bankers are not particularly interested in the accountant's actual annual income, but in the relation of the income from the particular client seeking credit to his total income. An accountant receiving 60% to 80% of his income from one client, it is stated, would not be able to maintain the necessary independent attitude of mind. SEC rules and Rule 13 of the Rules of Professional Conduct, relating to financial interest, are cited to support this view of the credit grantors.

Other factors besides the question of fee or financial interest that the author believes impair the independence of accountants are:

1. Accountant, or members of his staff, employed by client either part or full time.

2. Accountant relies on unverified information furnished by client.

3. Audit report submitted to management differs from report to bank.

4. Accountant employed employees of client to do detail work.

5. Agreement between client and accountant indemnifying accountant against liability.

6. Accountant acted as bookkeeper for the client.

Audits of School Districts

Those accountants who perform audits of school districts will find a complete discussion of the practice as followed in Illinois in an article by Ralph M. Hogan (*The Illinois Certified Public Accountant.* Summer 1957). Much of the material presented is of a general nature that would be of value to any school district auditor.

The Superintendent of Public Instruction at Springfield, Illinois distributes free of charge two publications—*The School Code of Illinois,* and *Guide for Classification of School Accounts*—for the guidance of the accountant. In addition, *Municipal Accounting and Auditing* published by the Municipal Finance Officers Association of the United States and Canada, 1313 East 60 Street, Chicago 37, deals specifically in Part Three with municipal audit procedures.

The first section under Part Three covers the basis of the agreement between the accountant and the municipal body. The second section contains a statement of audit standards applicable to municipal work, and the third discusses the type of report which should be submitted.

In his preliminary talks with the school board, the accountant should be quite specific in outlining the scope of his audit. A detailed audit of every transaction is unnecessary but, on the other hand, the audit cannot be limited to a short period or one fund. In the absence of unusual conditions a "limited general audit" as defined in *Municipal Accounting and Auditing* is the type that should be performed.

An Adirondack View

The AAM of the AMA began its flight the first of October. It is big for a satellite but there was jet power to push it off for a good start. This was easier because it keeps its feet on the ground instead of going round-and-round up in the air beyond the clouds.

The Academy of Advanced Management (AAM) was organized this year by the American Management Association (AMA), after the Trudeau San facilities, here in Saranac Lake, were acquired. All summer we natives have mostly gone without plumbers, electricians, painters and carpenters so that the San buildings could be changed into AAM buildings.

A week after the Advanced Management Course started, the Decision-Making Course started. The IBM 650 was greased, oiled—and cooled. The string of course lecturers started coming, and included CPA Arthur Toan.

Years ago businesses had to have office boys—now they have to have CPAs—well, at least one.

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
the "Adirondack Chapter."

Letters to the Editor

The Scope of Management Services

May I offer the following comments relative to the well-written evaluation of management services by Charles Lawrence in his article entitled "Management Services and the Accounting Profession" which was published in the October 1957 issue of *The New York Certified Public Accountant.*

For a number of years (before the current publicity relating to management services) certain progressive CPA firms had systems departments, whose work also included cost accounting and factory layout revision. Some CPA firms have long specialized, or employed specialists, in hotel, retailing, stock brokerage, bankruptcy, decedent's estate work and other fields.

I see nothing wrong or dangerous in an accounting firm accepting any of the foregoing assignments provided they can be properly handled and supervised.

However, I would agree with Professor Lawrence that extending management consultation and services to include "safety and health programs," "conducting market research," or "packaging methods" would represent a dilution of public accounting services rather than a proper extension thereof. If the profession is going to enter all fields which serve or service business entities, it will be difficult to maintain standards of professional work, and the problems of proper control and regulation of public accounting practitioners will be multiplied.

The more knowledge each CPA possesses, the greater will be his value to business. But, in my opinion, this value can best be exercised in a supervisory or reviewing capacity, rather than by making detailed surveys relating to marketing, research, insurance, employee training and other fields, which are already properly serviced by non-CPA specialists.

STEPHEN CHAN, CPA
New York, N. Y.

Accounting Principles and Procedures of Philanthropic Institutions

Members of the New York State Society of Certified Public Accountants will be interested in the lately published results of a survey on the recording and reporting of the financial transactions of philanthropic institutions. The report, entitled "Accounting Principles and Procedures of Philanthropic Institutions," is written by Louis Englander, C.P.A., partner of Apfel and Englander, C.P.A.'s, and former instructor in accounting at the City College of New York. Dr. Emanuel Saxe, Dean of the Bernard M. Baruch School of Business and Public Administration in the same college, served as special consultant in the project.

Compilation of the technical study, in progress over a year, entailed the analysis of financial reports of hundreds of eleemosynary organizations and round-table discussions with financial officials of many of them. The stated goal of the research was to assist in "the establishment of uniform accounting principles and procedures which will make financial reporting more useful to the institutions themselves and to the general public."

The 52-page report distinguishes the accounting problems of non-profit agencies from those of business establishments organized for profit, reviews prevailing techniques of recording and reporting and sets forth recommended practices. It accents the significance of

the budget, both as a compendium of an agency's needs and plans and as an implicit pledge that contributed funds will be distributed in accordance therewith. The monograph underlines the urgency of separating contributions into those received for the general purposes of an agency and those contributed for a special use or purpose, and stresses the importance of public reports on both classifications. Specific problems explored include the treatment of fixed assets and special types of contributed income as well as the segregation of costs and expenses so as to differentiate disbursements for philanthropic projects from those required to implement such purposes. These latter expenditures are grouped in three major categories: fund-raising; public information and education; and administration.

A final chapter, captioned "A Forward Look," states: "There is sufficient agreement in the major areas of recording and reporting to conclude that a statement of generally accepted accounting principles for philanthropic institutions can be formulated. The necessity for continued study is recognized." It is proposed that a committee of public and private accountants should engage in a further "testing of the principles" suggested in the report and a continuing search for uniform terminology.

D. Paul Reed, Executive Director of the National Information Bureau, fact-finding agency with respect to philanthropic organizations, stated: "This study will not solve all our problems but it represents an excellent forward step and an agenda for next steps." The inquiry is a "vitally important pioneering job" in the view of Albert E. Brownbridge, former director of the Contributors Information Bureau.

Copies of the report, priced at $1.50, are obtainable from the New York Community Trust, 71 Vanderbilt Avenue.

RALPH HAYES, Director
N. Y. Community Trust
New York, N. Y.

Tax Department Amenities—Foreign Version

In our day-to-day activities representing clients before the various tax departments on the local, state, and federal levels, we endeavor to deal with the taxpayer and the tax collectors in as fair a manner as we possibly can. At times our clients may feel that they are not given a reasonable interpretation of the law as it may affect them; then again, the governmental representative may be more than cooperative. In all of these relationships the human relations aspect is constantly at play.

A client of mine, who is a resident of Basle, Switzerland, recently sent the enclosed letter to my office. He thought it might be interesting to an American practitioner to learn how a foreign tax-collecting agency deals with its taxpayers.

I am sending it to you with the thought that it might be of interest to the readers of our publication. The following is a free translation.

We are glad to note that you sent in your Income Tax on time. In the rather complicated situation in which you are in respect to taxes, an attitude on your part is shown which merits an appreciation, since our task has been lightened.

We permit ourselves, therefore, to express our sincere thanks, especially since we have to warn others who are late.

Due to pressure of work, we cannot do this every year. However, we thank in advance, if you will do likewise in the future.

Leo L. Tauritz, CPA
New York, N. Y.

Bank Confirmations

I recently received a bank confirmation on which appeared a stamp placed by the bank as follows:

PRIVATE AND CONFIDENTIAL

The statements in this report are only opinions furnished in response to your inquiry, solely as a matter of courtesy, for your own use in strict confidence. You accept this report upon the condition that neither this bank nor any member of its staff shall be responsible for the accuracy of such opinions, nor under obligation to notify you of changes affecting such opinions.

It seems to me that if banks are to require audited financial statements from their clients, they in turn should be willing to assume a greater degree of responsibility than is displayed by this obvious qualification.

Noll E. Johnson, CPA
Binghamton, N. Y.

City Excise Taxes and Insolvency Procedures

Our office wishes to thank you for the publication of the article by Louis A. Sachs on insolvency procedures (May 1957 issue). We believe that it will be very helpful to all of the members of our staff engaged in this field, and we are making it required reading for everyone.

Leon I. Radin, CPA
New York, N. Y.

Book Reviews

Statistical Sampling for Auditors and Accountants

By Lawrence L. Vance and John Neter. JOHN WILEY & SONS, INC., New York, N. Y., 1956. Pages: x + 310; $9.00.

The realization that the auditor's "test" is a sampling procedure and as such is subject to the same type of approach, the same criteria, and the same type of problems as in other fields, is now receiving increased recognition.

It is only in the last few years that the auditors have come to the realization that they should restudy their methods. This question as to the desirability of the subjective approach has been reflected in a rash of literature dealing with the problem—almost entirely in the form of articles in professional publications. A further indication of the interest among accountants in this area may be seen in the formation of committees by the American Institute of Accountants and the New York State Society of Certified Public Accountants to examine the problem. The greatest handicap in this field has been the lack of appropriate books which would explore the problem extensively, providing the working auditor with sufficient knowledge of the statistical theory and methods of application so as to make possible the use of these modern tools.

This new volume is an attempt in this direction. From a statistician's viewpoint, this book represents an admirable summary of sampling theory together with some illustrations of applications to auditing and accounting problems. However, considering its objective, namely the development of the auditor's knowledge and understanding to the point that the technique may be applied to auditing checks, the volume does not seem to be adequate.

In the preface the authors make the forthright but very disappointing statement that, "As yet, the limited experience in the application of statistical sampling to auditing has not indicated in a definitive manner how these auditing formulations should be made in order to provide significant results." They then proceed to state that, "This book is not, therefore, a handbook telling the reader ready made ways in which statistical sampling techniques can be applied to any specific auditing or accounting problem." They then observe that, "We hope that this book will encourage auditors and accountants to experiment with the application of statistical sampling techniques so that a broad body of practical experience in this field will be developed."

While the ultra conservative might applaud this purpose, the stated objective does give rise to the question as to the desirability of such a cautious approach. While it is true that many problems confront those attempting the application of statistical sampling to auditing operations, the same difficulty was encountered in other fields where authors firmly confronted the problem and evolved recommended approaches while not attempting to solve all problems. A "do-it-yourself" book which presents the statistical techniques together with the admonition that the accountant must develop his own approach to the problems is not the most effective contribution. The authors have missed a golden opportunity to advance the field several years by a bold approach together with specific recommendations.

The literature of the field to this point has emphasized the "acceptance sampling" approach which has been borrowed bodily from the field of statistical quality control as applied in the factory. The other areas of statistical sampling have largely been overlooked. The desirability of acceptance sampling as the technique to be used in auditing has been subjected to little critical ex-

amination. Yet it is quite apparent to the statistician that this technique is not appropriate in many, if not in the majority of auditing applications. The use of estimation sampling methods and other forms of sampling techniques may well provide more useful techniques. In line with past literature, Vance and Neter place major emphasis on the acceptance sampling methods with considerable space devoted to an analysis of existing acceptance sampling plan tables, such as those published by the Department of Defense. Yet these existing tables are generally inappropriate for the auditor's use for a variety of reasons which are *not* emphasized by the authors. If the auditor is to use the acceptance sampling techniques, new tables of sampling plans must be developed.

Much less space is devoted to the methods of estimation sampling. This technique contrasts with that of acceptance sampling by providing an estimate of the relative frequency of the occurrence of errors or of their total or average magnitude rather than a mere decision to "accept" or "reject" as in acceptance sampling. Yet this promises to be a more fruitful approach to many of the accountant's problems.

In a section entitled "Auditing for Fraud," Vance and Neter dismiss, after brief discussion, a technique for determination of sample sizes which will provide a desired degree of insurance that at least one error will be disclosed in the sample, if it exists with a certain minimum frequency. The dismissal is based on the grounds that "the major purpose of the audit is not to look for fraud . . ." Without challenging this conclusion, the question may still be raised as to whether this method might nevertheless be fruitful in discovering examples of failures to adhere to internal control systems and other examples of errors that might cast doubt on the system or, for that matter, the validity of the financial statements.

The cases of application of statistical methods to auditing and accounting problems described in this book are both useful and provocative. The section on controlling the accuracy of clerical work will be of great interest to the internal auditor. All of the techniques the auditor might use are discussed in this book. However, in spite of the statement by the authors that the book is written on the assumption "that the reader will have had relatively little previous training in statistics and practically none in the field of statistical sampling," the average auditor who has not had formal training in this field will find the volume to be difficult reading.

There is every indication that in the not too distant future, statistical sampling will be widely used and perhaps will be the "accepted" approach. To provide the necessary understanding and the appropriate working tools, books which will provide various types of sampling tables *designed for auditing use*, together with better oriented discussions of the techniques, will be desired. There is no easy way out. We cannot merely borrow methods used in other fields. The design must be appropriate to the application. Accountants and statisticians working together will provide the means. To accomplish this, the interest of accountants in statistics must be developed, while the statisticians must become interested in the specialized problems of auditing.

In spite of the above criticism, this volume must be considered an outstanding contribution in a relatively new field. It will accelerate its development considerably.

HERBERT ARKIN

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Business Statistics Division,
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Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $6.50 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Justin Jacobs, Peter P. McDermott & Co., investment information, portfolio analysis, no charge for these professional services. DIgby 4-7140, 42 Broadway, New York 4, New York.

Statistical Typing, IBM typography, offset printing. Gitsham's, 480 Lexington Avenue, N. Y. 17, PLaza 5-6432.

CPAs, N. Y., N. J., Conn., W. Va., AICPA, established over 20 years, heavy taxes, management (IE, MBA), substantial cash, seek practice, accounts. Box 1263.

Practice Wanted, substantial terms, know-how offered overburdened or retiring practitioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 1264.

Attorney-CPA, over 40, exceptional background, seeks association with CPA, or CPA-attorney wherein professional backgrounds, ability and experience of writer can be fully utilized, will purchase interest. Box 1265.

CPA, AICPA, former partner small national firm with top level experience desires purchase of accounts or practice, New York area, prefer practice of about $50,000 gross, have profitable practice of about $40,000 and adequate cash capital, greatest tact and diplomacy, replies will be held in strict confidence. Box 1266.

CPA, with self supporting practice in L. I. will join with younger practitioner in similar position for the purpose of growth, economy and thought of retirement. Box 1267.

N. Y. City CPA Firm seeks a CPA of principal caliber with a practice and with some available time, partnership opportunity, state particulars which will be treated confidentially. Box 1268.

Small Office Space, private, midtown, nicely furnished, telephone and all facilities available, quiet environment, very low rental. CH 4-4744.

BUSINESS OPPORTUNITIES

Northern New Jersey, CPA, N. Y., N. J. 43, extensive experience, established office, desires merger or branch arrangements with larger firm for mutual benefit. Box 1270.

Office for Rent, Lindenhurst, L. I., rare opportunity for CPA, beautiful offices in shopping center, 800 car parking. Call Karp, TUrner 8-1683.

CPA, grossing $50,000 annually with small staff, interested in associating with practitioner similarly situated. Box 1271.

Small Private Office, midtown, $50.00 per month. LOngacre 3-6526.

CPA, Nassau-Suffolk practice, gross $25,000, wishes to associate with practitioner or larger firm for mutual benefits and potential. Box 1272.

CPAs, 2, members N. Y. State Society and AICPA, modest practice, extensive accounting and tax experience, desire purchase of established practice or association with practitioner looking towards eventual retirement, capital available. Box 1273.

CPA, desires office, preferably in midtown Manhattan. Box 1275.

Attorney-CPA, mature, top level experience, seeks association with overburdened or retiring practitioners, percentage or purchase interest. Box 1276.

CPA, attorney, 33, $12,500 gross, experienced managing larger practice, wishes to associate with CPA or CPAs aware of importance of strong organization progressively oriented. Box 1277.

CPA, with extensive public accounting and tax experience, grossing $15,000, seeks partnership or other association with overburdened or retiring upstate practitioner or firm. Box 1280.

SITUATIONS WANTED

Immediately Available, accountants, office managers, bookkeepers. Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42nd Street, N. Y. C., telephone LOngacre 4-1740.

CPA, age 32, 7 years diversified large and small firm experience, seeking per diem work. Box 1256 or WO 4-4368.

CPA, age 33, 14 years diversified public accounting and tax experience, seeks supervisory position with potential growth. Box 1257.

CPA, 20 years diversified public accounting experience will service accountant's clients upstate New York, daily or job basis. Box 1258.

Assistant Comptroller, CPA, law degree, presently employed, seeks better opportunity, over 25 years diversified experience, public and private, office management, financial statements, internal controls, credits and collections, taxes. Box 1259.

Suffolk County Accountants, senior accountant seeks per diem employment with CPA on Suffolk County audits, will work independently and follow audit programs without supervision. Box 1260.

Accountant-Attorney, age 28, 1½ years N. Y. C. Bureau of Excise Taxes, seeks opportunity to acquire federal tax experience with tax department, public or private firm. Box 1261.

CPA, Society member, 30, single, nine years diversified public accounting experience, seeks challenging position in public or private accounting, minimum salary $8,000. Box 1262.

Full Charge Bookkeeper, desires homework, 10 years experience, will pick up and deliver work. AS 8-6495.

Tax Attorney, female, ten years with CPA firm, experience research, preparation returns, protests, Federal, State, local, $6,500 Box 1269.

Part-time, CPA, Society member, small own practice, 15 years diversified experience, including taxes, available per diem or job basis, 10 days monthly or less. Box 1274.

CPA, MBA, honor graduate, Society member, young, six years diversified national and small firm experience, desires position with partnership possibilities. Box 1278.

CPA, with long audit and tax experience, desires part-time connection, can give full time in heavy audit and tax periods, no conflicting activity, compensation moderate. Box 1279.

Comptometer Operator, desires per diem work several days a month, 12 years CPA experience, all operations, hours 10-4:30. Box 1281.

The President's Page

The Chapters

This Page is being written shortly after the conclusion of a series of trips to the upstate chapters which constitute the annual officers' visitation. Seven strong – president, first vice-president, secretary, treasurer, executive secretary and chairmen of the Committees on Chapter Operations and Chapter Expansion – we made the rounds of Binghamton, Syracuse, Albany, Rochester and Buffalo. Many impressions are still fresh in my mind.

Uppermost is the cordial hospitality which was extended to all of us, not only by the chapter officers but as evidenced by the excellent attendance at the meetings. I cannot but again express publicly our thanks for the warm welcomes.

Next was the keen desire on the part of the chapters to serve both the Society and the profession. Wherever we went we were met with the question, "What can we do to help?" Our chapters evince a strong identity with the Society, a singleness of purpose, and a desire for guidance so that they may do the right things to further our mutual interests. Within themselves there is an awareness of their strength and the will to use it; no uncertainty, no doubt, no vacillation mar their approach to the future.

Impressive too was the excellent planning as evidenced both by the meetings which have been arranged and the programs of the several chapter committees. My predecessors and I have told the chapters that one of their most important contributions is in the field of public relations. That they have heeded this counsel is proven by the many meetings arranged with attorneys, bankers, creditmen and others. Indicative of the progress of the chapters in this area of our activities is the fact that this year our Public Relations Clinic will be held in Rochester on November 16th. A most interesting program has been

arranged by Don Margolis, acting on behalf of the Public Relations Committee headed by Dave Zack.

On our visits to Rochester and Buffalo we attended luncheons to which local legislators were invited. We were thus afforded an opportunity to apprise them of our regulatory legislation program and to hear their reactions. We made many friends among them. At Syracuse we lunched with Senator Wheeler Milmoe and enlisted his support. We took advantage of the opportunity to tell the chapter members of our present plans regarding regulatory legislation and to point out how they may help. Thus did the chapters enable us to launch this most important program, details of which I intend to present in my next President's Page.

In their internal operations too, the chapters were most impressive. Committees have met and plans for the current year are well under way. Of particular interest were the arrangements already consummated, those in process, and those just beginning, to provide machinery to help members who because of ill health cannot carry on their practices, and to guide widows or heirs of deceased members in preserving and disposing of the decedents' practices. Variously described as "emergency assistance" and "continuity" programs, they all are promulgated with the guidance of our Committee on Continuity of Practice of which Albert Krauter, one of the first to interest himself in this field, is chairman.

Although they may not have realized it, the chapters probably told us more than we them. Not always by word of mouth, not always intentionally, and not always with an awareness of our keen interest, did they inform us of their objectives, their activities and their plans. The superb performance of the upstate chapters included in our annual visitation, is equalled by our other chapters, Richmond, Nassau-Suffolk, Westchester and Mid-Hudson. No one chapter can be singled out for special commendation. All are cooperating in a unified and inspired effort to advance the interests of the public, the profession and the Society.

LEONARD PRICE,
President

The Verification of the Existence of Assets

By Donald J. Bevis, C.P.A.

In reviewing the fundamental principles and auditing techniques applicable to the verification of assets, the author concerns himself with such practical considerations as the time of confirmation and inventory observation, alternative procedures and use of independent experts.

Introduction

The ultimate objective of the auditor in the ordinary examination of the annual accounts of an enterprise or in an investigation of special matters is the expression of an informed opinion or conclusion on the financial statements of the enterprise or on the matters under investigation.

This paper deals with the problems or questions that are encountered in that phase of the examination or investigation relating to the verification of the existence of assets. The word "verification" is used hereafter not in the sense of "proving something to be *true*" or of "establishing the *truth* of something," but in the auditor's accepted sense of establishing or proving the *general fairness* of the matter under investigation by relying upon a system of carefully devised testing.

For the purpose of this discussion it is presumed that the auditor is a professional man and conducts himself in accordance with the ethics and standards of his profession. The generally accepted auditing standards (as distinguished from auditing procedures) of independent certified public accountants in the United States require that the examination or investigation be performed by a person having adequate technical training and proficiency as an auditor, that in so far as the assignment is concerned he maintain an independence in mental attitude, and that he exercise due professional care in the performance of his work. In performing the examination it is essential that the work be adequately planned and supervised; that there be a proper study and evaluation of the existing internal control for the purpose of determining the extent of the audit tests to be per-

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Donald J. Bevis, C.P.A., *is a partner in the firm of Touche, Niven, Bailey & Smart. He has served as chairman of the Committee on Auditing Procedure of the American Institute of Certified Public Accountants and is a former president of the Michigan Association of CPAs.*

This article was originally presented as a paper before the 1957 International Congress of Accountants.

formed; and that sufficient competent evidential matter be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion.

Audit of Annual Accounts

The principle has been established that the financial statements upon which the auditor is reporting are the representations of management. Management has the direct responsibility for the maintenance of an adequate and effective system of accounts and for safeguarding the assets. The auditor's representations are expressed in his report or opinion, which reflects his personal judgment as to the general credibility and fairness of the statements. His examination is not designed and cannot be relied upon to detect defalcations and other similar irregularities, particularly those that involve collusion.

It is important to recognize at this point that the auditor, in connection with his examination of the annual accounts, usually is asked to give his opinion on the income statement, as well as the balance sheet. Therefore, in determining the procedures to be followed in the verification of the existence of assets, appropriate consideration must be given to all aspects of the examination, and not to the balance sheet alone, and to the fact that some audit procedures are designed to test the validity of figures in both statements.

The auditor in rendering the usual opinion on the financial statements does not state that he has made an exact and complete verification of the figures on the statements. The objectives of an audit do not require such an extensive scrutiny. Furthermore, it cannot be presumed that the figures should be exact figures. Accounting values of most items in financial statements cannot be determined exactly. They are subject to many variable factors, including accounting conventions, industry practices, and judgments of individuals. The determination of those values also is often complicated by the inability to measure exactly the physical volume or quantity of the assets.

The auditor's opinion is the opinion of an expert in accounting and auditing, based upon an adequate examination for the purposes required of the underlying data. The scope of his examination takes into consideration, and its extent will vary in accordance with, the materiality of the separate items in, or affecting, the financial statements and the relative degree of risk of occurrence of material inaccuracies. Since the fairness of the financial statements will be more seriously affected by a misstatement of a material item, a relatively greater amount of evidential matter must be examined or tested in support of a material item than would be necessary in support of an immaterial item. Greater attention must also be given to those items or spheres of activity in which material error or fraud could be expected to exist, in contrast with those items which are least susceptible to error or fraud.

The auditor need not, except in the most unusual case, make a detailed audit of all transactions. The nature of the audit procedures employed and the extent of the tests of the records and selected transactions are a matter of judgment and will depend to a large degree upon his appraisal of the adequacy of the system of internal control. One of the principal purposes of internal control is to minimize the possibility of error or irregularity. The more adequate and effective the system, the less extensive the amount of testing that is required. Where internal control is limited or restricted, a more comprehensive audit and a greater amount of testing

will be required. Ordinarily, the small concern will have a weak system of internal control, the medium sized concern will have an adequate system, and the large concern will have an extensive system. The system of internal control of the large organization is usually typified by the existence of some degree of internal audit.

In summary, therefore, it can be stated that the nature and extent of the specific audit procedures to be employed in the verification of the existence of assets depend upon: (1) the materiality of the item to be audited, (2) the probability of finding material inaccuracies, and (3) the evaluation of the system of internal control, including the methods followed by the enterprise in physically controlling and accounting for the assets.

Investigations

In a special investigation the audit procedures to be employed will depend upon the character and purpose of the examination and the type of report desired from the auditor. The nature and extent of these procedures may vary for several reasons from what would be required in the examination of the annual accounts. In the first place, the purpose of the examination may dictate that different procedures be employed. Secondly, a greater or lesser degree of assurance on the part of the auditor may be required, with a consequent expansion or reduction in the audit procedures employed and the extent of their application, depending again upon the purpose of the examination and the expected results. Further, in a special investigation the auditor usually is restricted to a specific item or one phase of the operation of an enterprise. Because of this limitation and the resultant inability to obtain reasonable knowledge of the whole, he is in a less favorable position to form an opinion on the adequacy of the system of internal control, and he is not in a position to benefit from the knowledge he obtains from other audit procedures and tests that would be performed in the examination of the annual accounts. Hence, the audit procedures employed may have to be more comprehensive, and the extent of his tests of the item or phase of the operations may have to be greater than might otherwise be necessary in order to give him the assurance he requires to render the expected opinion.

In any event, if the investigation involves the issuance of a report by the auditor, the substance of the generally accepted auditing standards mentioned previously in this paper still applies.

Types of Assets

Irregularities due to fraud or dishonesty are more apt to occur when the asset is readily accessible and mobile, has a relatively high value, and is easily negotiable or convertible into funds. Assets that have these characteristics include the following:

1. *Cash*—which ordinarily can be used by the abstracter without major difficulty of conversion.

2. *Marketable securities and other negotiable instruments*—which are readily negotiable without endorsement into cash or its equivalent.

3. *Stocks of raw materials, work-in-process, and finished products*—the use of which by fraudulent conversion depends upon their ready marketability or use by the possessor.

4. *Certain types of machinery and equipment, furniture and fixtures, etc.*—which have the same characteristics as the inventory items mentioned above.

5. *Bank account balances, receivables, and certain securities*—the improper use of which requires only fraudulent endorsement or forgery.

It is to these types of assets that greater auditing attention and more extensive tests need be applied in order to assure the auditor that, as of the date of the annual accounts or investigation, there is a reasonable presumption of the existence of these assets. It will be observed that the greater risk generally lies in items that are classified as current assets, as distinguished from fixed assets. It is also to be noted that the greater risk lies in items that have a higher turnover and can more easily be substituted. There usually is little exposure in fixed assets with little or no turnover, and which normally cannot be substituted, such as land and buildings or intangibles.

The probability of bookkeeping errors also has some relationship, if it does not vary directly, with the rate of turnover. The larger the number of bookkeeping entries required, the greater the statistical chance for error. Bookkeeping and accounting errors also may arise out of incompetence, inattention, or improper supervision. The auditing procedures employed should take these factors into consideration.

Audit Techniques

The techniques that the auditor follows in the verification of the existence of assets, in the examination of the annual accounts or in a special investigation, can be summarized as follows:

1. Analysis and review of data in the company's files and records and data obtained by the auditor in the course of his examination.
2. Observation of accounting and internal control procedures.
3. Inspection of physical assets, documents, and other supporting evidence.
4. Confirmation of items shown on the records by direct communication with an authoritative person in a position to verify the items.
5. Inquiry of officers and employees, legal counsel, etc.
6. Computation of figures in the records or books of account.

In the majority of cases each of these techniques must be applied before the auditor can obtain satisfaction as to the general fairness of any item under investigation. For example, with respect to stocks of raw materials, work-in-process, and finished products, the auditor will have to analyze and review data pertaining to the purchasing, receiving, and accounts payable departments to satisfy himself that the company has title to the inventory. He will have to observe the procedures followed in taking physical inventories and inspect selected items. Often he may have to obtain confirmation as to inventory belonging to outsiders or out on consignment, and he will make inquiry of officers and employees as to obsolete and excess inventory items. Tests will have to be made of the arithmetical accuracy of the inventory prices, extensions, and tabulations.

It is the composite knowledge that the auditor obtains from all required procedures and tests that enables him to express an opinion on the matters under investigation. He does not rely completely upon any single procedure, such as physical stocktaking.

Physical Stocktaking

The presence of the auditor during the time of physical stocktaking usually provides the best independent means of verifying the accuracy of balance sheet items. Without having the knowledge that comes from direct contact with physical stocktaking, the auditor is not in a position to appraise whether the procedures are good and should result in a reasonable determination of the inventory for accounting purposes. He must rely, otherwise, on representations

of management of the company and the people directly responsible for taking the inventory. His observation of the procedures followed and inspection of selected items give him some direct assurance as to the bona fides of the inventory.

Physical stocktaking provides a check on the reliability of the accounting procedures and costing techniques through a comparison, with all of its ramifications, of priced physical inventories or physical quantities with the inventory amounts shown by the accounting records. The correctness of interim financial statements of an enterprise (or the year-end statements if physical inventories are taken in advance of the end of the year) depends to a major extent upon the accounting and cost procedures employed to produce them.

Physical stocktaking, by developing and pointing out differences, is thereby a means of checking and proving the adequacy of internal organization and other phases of internal control. For example, are the established procedures for the control of receiving and shipping of materials functioning properly? Have reasonable safeguards been provided to prevent theft of valuable merchandise? The best way of satisfactorily answering these questions is to be able to demonstrate that opening inventories, plus purchases and production, equal sales, plus closing inventories. There are few cases, however, where it is necessary or worthwhile for the auditor to spend the time required to ascertain that quantitative relationship if it has not been established by the company. There are other tests that can be performed in a lesser amount of time that not only will give him reasonable answers to this question, but also will answer many other questions as to the adequacy of other related and unrelated accounting and internal control procedures. Internal control, once instituted, cannot be presumed to be continuous in all aspects; it frequently breaks down through discontinuance of checks and of operations believed to be in effect by management, but which are no longer carried out.

The foregoing discussion of physical stocktaking has been directed primarily to stocks of raw materials, work-in-process, and finished products. The observations or conclusions are, however, applicable to other types of assets that are subject to physical control procedures. For example, the verification of the existence of cash on hand, securities and other negotiable instruments, and items of machinery and equipment can be accomplished by a physical inventory. The results of the physical inventory also can give some assurance as to the adequacy of the internal control procedures.

Certain characteristics of physical stocktaking are also present in the examination of receivables and other assets. Trial balances or detailed listings of these assets are an essential part of the examination process, although in the case of receivables they cannot be conclusive as to their bona fides. Direct confirmation from the debtor is the best means of proving the existence and authenticity of receivables.

Date of Physical Examination of Assets

If the major purpose of the verification of the existence of assets is to establish their general fairness as of the date of the audit, obviously the ideal would be to have a complete and simultaneous inventory and check of all items on that date. This would eliminate the possibility of substitution to cover up shortages, and the additional auditing procedures and tests required in the reconcilements of inventories of assets at one date to the amounts shown in the accounts at another date. On the other hand, a practice of taking all inventories on the

audit date eliminates any benefits that can come from surprise examinations, and normally only discloses conditions existing at one time and not during the year. When inventories are taken during the year or at odd times, the element of surprise sometimes can be injected. By having more frequent contact, the possibility of unobserved breakdowns in control procedures is considerably lessened. More frequent contact also should give the auditor greater assurance as to the fairness of the income account.

The observance of a practice of complete and simultaneous inventory is of greater importance in special investigations. In such cases, because of the restricted nature of the examinations, the auditor usually does not have the same degree of familiarity with the system of internal control as he does in the audit of the annual accounts. Therefore, he cannot place as much reliance on the internal accounting and, from the standpoint of his reporting responsibilities, he normally is not concerned with it.

For various reasons the ideal seldom can be attained, particularly in the examination of the annual accounts. Many companies take their physical inventories of raw materials, work-in-process, and finished stock at a time when the inventories are lowest, or when production demands are the least, or when there is the greatest availability of man power. These dates will not necessarily coincide with the end of the fiscal year. Perpetual inventory controls and records are an essential part of the operations of other companies. The reliability of these controls and records is checked throughout the year by comparison with physical inventories; no complete annual inventory is taken. As a part of his examination, the auditor makes tests of these physical inventories.

Also many companies, because of the limitations of time on their employees, prepare detailed listings and analyses of their receivables one or two months in advance of the end of the fiscal period. These listings must be used by the auditor. There can be no objection to this practice if there is reasonable internal control. Furthermore, since a very large number of companies close their accounts on a calendar-year basis, auditors, because of practical limitations on their own time and personnel, have encouraged their clients to take their inventories at other dates. This has also had a salutary effect on the client; his audit has not been subjected to extreme pressures of time and urgency, with the attendant chances for error and neglect.

In brief, the further the practices of the company and the auditor depart from the ideal, the tighter and more effective the system of internal control, and the more extensive the audit procedures and tests must be. In this connection, however, it should be noted that the degree of adequacy of internal control is not always uniform between assets or phases of the operation of a company. This can result in relatively more or less extensive audit tests in some areas than in others.

It is not practicable to set forth a precise rule as to the date of physical examinations of assets, or the intervals between such examinations, by the auditor. These determinations must be based upon the accounting and control procedures followed, the rate of turnover of the assets, their convertibility or negotiability, and the probability of occurrence of material inaccuracies in the accounts since the previous inventory. All of these factors are interrelated and the timing, or frequency, of the physical examinations will have a direct relationship with the seriousness of the findings.

If the accounting and control procedures are relatively poor, there exists the possibility of shortages and material inaccuracies in the accounts. Obviously in such cases there cannot be much au-

thority attached to tests performed by the auditor far in advance, or for a period far in advance, of the date of the annual accounts or investigation. Unless he repeats these tests at or near the audit date, he cannot obtain reasonable satisfaction with the accounts at that time. The converse of this proposition is also true—the more reliable the accounting and control procedures, the less extensive the audit tests and the further the time of the physical examination can be separated from the audit date.

Likewise, it is generally true that, where turnover is slow, the frequency of the audit tests can be reduced. Where turnover is higher, the chance of bookkeeping errors is greater; accordingly, less reliance can be placed on tests performed in the past and more reliance must be placed on current control procedures and audit tests.

The element of surprise can be important in the application of auditing tests, in that there is a better chance of disclosing shortages or irregularities if the person being audited does not have advance information. However, with the increase in the size of business and the number of transactions, and the consequent improvement in internal controls, the detection of fraud and embezzlement is no longer considered by the user of audits to be of major importance; and, accordingly, the usual examination is not designed for that purpose, although the discovery of irregularities frequently results.

On the basis of the propositions developed in this paper and under the assumption of adequate internal control, it would appear that the auditor is justified in examining certain assets less frequently than once a year. These would include fixed assets, such as land, buildings, machinery and equipment, and assets that have been held in bond or to which access has been restricted. Further, it would appear that physical inventories of raw materials, work-in-process, and finished products (or at least a substantial portion thereof) should be taken at least once during a year; and the auditor should be present during the period of inventory taking to observe the procedures followed and make tests of the quantities. Physical examinations of material amounts of cash and securities and other negotiable instruments should be made as of the audit date, or reasonably close thereto. In all cases there is the presumption that the auditor will make some review of the intervening transactions between the time of the physical examination and the date of the audit.

Other Procedures

Since 1939 the auditor in the United States has been required to observe inventories and confirm receivables where either of these assets represents a significant proportion of the current assets or of the total assets of a concern. There has been no substantive change in these mandatory procedures since that time. Failure to apply these procedures, where they are practicable and reasonable, in general precludes expression of an opinion on the fairness of the financial statements taken as a whole. Many people felt when these procedures (particularly the requirement for observation and attendance at inventory taking) were adopted that they took the auditor out of his proper sphere and placed upon him responsibilities for which he was not equipped, either by training or in personnel, to assume. Subsequent experiences have demonstrated, however, that the auditor was capable of meeting his new responsibilities. The new procedures required the auditor to be familiar with the company's inventory plans and organization and to be present during the period of inventory taking

to satisfy himself that a reasonable inventory was being taken. The new procedures did not take away from the company its responsibility for taking the inventory and the determination of quantity, quality, and condition of the inventory items.

There are no acceptable alternative procedures to these required procedures, using "alternative" in the sense of equal value, effectiveness, or rank. Any other procedures employed in lieu of the mandatory procedures can only be considered to be substitute or other procedures, but not alternative procedures.

It is difficult in a paper of this length to give adequate consideration to these "other" procedures. They will vary with differences in practices between companies and with the nature of the items under investigation. Two examples, however, can be cited. In the case of the verification of receivables, investigations of subsequent collections and adjustments have been made in lieu of confirmation with the debtors. Verification of the existence of merchandise being held by depositories or on consignment with outsiders has been made by direct communication with the holder or consignee, instead of by physical inspection. The use of these other procedures can give the auditor some satisfaction, but certainly not the assurance he obtains from following the procedures of direct confirmation of receivables and observation or inspection of the physical inventories.

In some areas of the audit process where physical determinations are an important factor, physical evidence is not always the best evidence. For example, in the case of a cash count the bona fides of coin and currency can usually be established by inspection. However, better proof of the authenticity of a check included in that count can be obtained by confirmation, rather than by inspection.

Ownership of Assets

During the course of an examination it is frequently found that the company has in its possession assets belonging to other parties. In the verification of the physical existence of these assets the same audit procedures should be followed as in the case of assets owned by the company. The principal auditing problem in such situations arises in establishing the accountability of the company to the third party.

Use of Independent Experts

Ordinarily, in his verification of the existence of assets for the purpose of expressing an opinion on the annual accounts, the auditor does not need specific technical knowledge of the products or manufacturing processes to satisfy himself as to their existence, quantity, quality, and condition. It is the company's responsibility to organize and take the inventory; it is the auditor's responsibility only to satisfy himself as to the general fairness of the inventory. In making his examination, in addition to observing the physical stocktaking procedures, he performs certain other audit tests, which in the aggregate give him the information he needs to express an opinion. If internal control is reasonably adequate, the auditor can ordinarily obtain independent corroboration and technical assistance from the company's own experts. This fact, together with the knowledge that comes from his other auditing procedures, normally would eliminate any necessity to get outside technical assistance.

A detailed discussion of these other procedures is outside the scope of this paper; but a listing of a few of the more important procedures and policies of the company, of which the auditor would have knowledge through his tests, and which would aid him in reaching an opinion, would include:

1. Purchasing policies.
2. Receiving and shipping controls.
3. Material handling procedures.
4. Use of formulas, bills of material, parts lists, etc.
5. Policies with respect to scrap and obsolescence.
6. Quality control and inspection.

There are, however, some situations where the auditor might desire outside technical assistance. In the case of special investigations, for example, of a processor of drugs and chemicals or a jewelry firm, the auditor could find the advice of independent experts to be necessary before he could form an intelligent opinion on the inventory, because of his limited knowledge of the internal control and accounting procedures and his lack of technical knowledge of the business.

Conclusion

The foregoing discussion of the problems or questions that are encountered by the auditor in the verification of the existence of assets has not at all exhausted the subject. There are many fields that require further exploration and investigation. There are other areas where there are still differences of opinion between equally competent professional auditors. It is to be hoped that this Seventh International Congress of Accountants through the interchange of ideas among people of good will will aid in the further development of a relatively new, but most needed profession.

The Calendar and Accounting Reports

The calendar, as it is presently constituted, is a handicap to the accountant in his endeavor to provide management with reports of maximum usefulness. Meaningful comparisons between successive months or quarters. or between similar periods in different years, is not possible without an explanation or reconciliation of the differences that arise because of the varying number of calendar and work days in these periods. The fluctuation in the number of calendar and working days available is caused by the number of days lost to the Saturdays, Sundays and holidays within the period and to the varying lengths of the periods.

Of equal significance is that fact that, under the Gregorian calendar, a month or quarter may end on any day of the week. As a result, the accountant is forced, at the end of the month or quarter, to relate costs and other information processed on a weekly basis to months and quarters which include partial weeks. This not only imposes an additional burden on accounting and operating personnel, but also leads to delayed reports or to estimated figures for a part of the period.

MODIFYING THE CALENDAR TO MEET
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Employer-Financed Medical Payment Plans

By ALLAN A. BAKST, C.P.A.

Although wage continuation plans have received the greater emphasis in current tax literature, medical payment plans can frequently offer equally advantageous benefits to taxpayers.

Because of the greater concentration by practitioners on the more complex aspects of taxation, tax economies of a moderate nature can sometimes be overlooked. It is the objective of this article to discuss one such available tax saving which as been overshadowed by more publicized Code provisions and their detailed interpretive problems.

Employer-financed medical payment plans[1] offer virtually unmatched fringe benefits to favored employees. Skillful utilization of such a plan may permit employees to circumvent the limited nature of the medical expense deduction.[2] Not only are the employer's expenditures fully deductible under such a plan, but the economic benefits inuring to the employees also escape taxation. In essence the advantages derivable resemble those accorded group life insurance.

Medical payment plans, along with wage continuation plans and plans to indemnify for loss of limbs or other dismemberment, fall within the broader classification of "Accident and Health Plans." In general, an employer-financed accident and health plan[3] involves an undertaking to reimburse employees, either in whole or in part, for losses they sustain resulting from accident or illness, such as medical, hospital and surgical expenses, as well as indemnification for the loss of earnings.

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The Situation Under the 1939 Code

To facilitate an understanding of the present statutory approach, some historical perspective is necessary since statutes are invariably understood more readily in the light of historical experience. Justice Holmes' aphorism "In the law a page of history is worth a pound of logic"[4] is completely apropos.

The 1939 counterpart[5] of the 1954 Code sections[6] provided that amounts received by employees through "accident or health insurance" as compensation for personal injuries or sickness, together with any damages received on account of such injuries or sickness, should be excluded from gross income. At the time the 1954 Code was proposed, the treatment of such benefits was plagued with uncertainty over what constituted a contract of "insurance."

Although the Internal Revenue Service conceded that payments to ailing employees made under commercial insurance qualified for tax-free treatment, it refused to concede the same favorable treatment to payments made by self-insuring employers.

It was regarded by the Service as grossly unfair to permit employees to receive an economic benefit without the incurrence of a corresponding tax. When the arrangements were correlated with the particular employee's wage scale, the inequity of excluding payments in lieu of wages from the tax base while including earnings, was even more patent.

The Service determined that it was powerless, in view of the clear mandate of the statute, to tax employee beneficiaries when their employers had financed the plan by the purchase of commercial insurance. However, premised on the aforementioned policy consideration, it was resolved to narrowly limit the ambiguous term "insurance" to conventional commercial insurance. Accordingly, the Service contended that payments made by self-funding employers did not constitute "accident or health insurance" and the receipts of their employees were considered taxable income. This rather artificial argument was made even though the coverage offered by self-insuring employers was identical and coextensive with that offered by commercially insured employers. The Supreme Court[7] has since adjudicated the issue in favor of the employees of self-insuring employers, but the uncertainty existing in 1954 impelled Congress to enact corrective legislation.

Changes Effected by 1954 Code

The historic accident and health payment exclusion has been extended and particularized by the three integrated sections[8] located in the exclusion area of the 1954 Code. No distinction in treatment is provided as to whether the employer is or is not a self-insurer.

On first blush, the approach adopted by Sections 104(a) and 105(a) would seem to require the inclusion of accident and health benefits attributable to the employer's contribution; however, the effect of Sections 105(b) (c) (d) and 106 is to exclude all employer payments with the exception of wage continuation payments in excess of $100. More specifically, with respect to employer-financed medical payment plans, Section 105(b) provides an exclusion for amounts paid employees, without limitation as to amount (except amounts paid employees attributable to and not in excess of medical expense deductions of prior years), in reimbursement of the medical care expenditures of the employee, his spouse and dependents. The payments must be for actual medical expenses; payments made merely because of illness do not qualify. To illustrate the foregoing, if an employee is ill and spends $200 for medical care and his employer reimburses him for these expenses, the reimbursement is excluded from the employee's gross income.

A Formal Plan Not Required

Formal requirements need not be present in order to establish the existence of a "plan." The Service has interpreted the concept of a "plan" in a most liberal manner and thereby avoided making its interpretation a new focal point of litigation. According to the regulations[9] a (medical payment) plan is the arrangement for the payment of amounts to employees in the event of personal injury or sickness. The plan may either be insured or non-insured. It may cover one or more employees and there may be different plans for

different employees. Furthermore, the plan need not be in writing and the rights of the employees to benefits may be unenforceable. In the event, however, that the employees' rights are unenforceable, there must be a program, policy or custom having the effect of a plan and notice or knowledge thereof must be reasonably available to the employees.

From the above it may be concluded that the Congressional response to the professed defects and inequities of the 1939 Code was to abolish the artificial distinctions and put commercially insured and privately insured plans on a parity. Obviously, Congress decided, on public policy grounds, to grant a uniform tax exclusion to medical payment plan receipts. Employers are thereby empowered to offer employees a most desirable fringe benefit. Employees in a highly fluid position, such as shareholder-officers of closely held corporations, may utilize medical payment plans as ideal vehicles to accomplish favorable tax results.

Overcoming the Limitation on Medical Expense Deduction

It was previously impossible for a taxpayer with a high adjusted gross income to obtain a tax benefit for small or even moderate expenditures.[10] The maximum statutory limitations similarly precluded the deductibility of abnormal medical expenses. Now, a way has been provided to obtain a tax deduction for all medical expenses of an employee, whether they be small, moderate or large.

For instance, consider a situation where an employee has incurred $1,000 of medical expense in a year in which his adjusted gross income amounts to $30,000. Under the percentage qualifications in the Code, only $100 would be deductible, the balance of $900 would have to be paid out of after-tax dollars. However, if the taxpayer's employer had defrayed the $1,000 of medical expense, the employee would not have had any additional taxable income and the employer, at the same time, would have been permitted a $1,000 deduction. Assuming the employee was in the 50% tax bracket, he otherwise would have had to earn $1,800 of income in order to pay the $900 of non-deductible medical expense.

Medical Payments vs. Compensation Increase

Employer adoption of a medical payment plan is considerably more beneficial to an employee who has incurred medical expenses than would be a correspondingly large compensation increase. Under either alternative the employer would obtain a deduction in the identical amount, but the tax consequences to the employee, as shown in the above example, are considerably less favorable when characterized as additional compensation than when classified as medical expense reimbursements.

Employers are also enabled to trade on this benefit in attracting and holding key employees who are sufficiently sophisticated to accept the employment which yields the maximum number of after-tax dollars. Employers will be able to effect economies by offering employees supplementary medical payment plans. To illustrate: Corporation in the 52% bracket hires key employee in the 50% bracket. It would cost the corporation $480 to reimburse each $1,000 of the key-man's medical expenses. But, if instead the corporation were to provide an increase in salary, sufficient for the executive to pay the $1,000 of medical expense, the cost to the corporation would be $960 because the salary increase would have to be $2,000 (assuming in the instant case that the employee does not qualify for any medical deduction). This differential obviously repre-

sents a substantial saving especially when many employees are involved.

Absence of Restrictions on Discriminatory Features

The Code does not prescribe the minimum or maximum number of employees to be covered by a medical payment plan. The regulations recognize the existence of a plan if only one employee derives benefits irrespective of the total number of uncovered employees.[11] The relative absence of objective criteria in this area gives employers full leeway to develop plans in full accord with their personal and discriminatory predilections.

The original version of the House of Representatives bill[12] which eventually became the 1954 Code provided for an exclusion only when the amount was received under a "qualified" plan which satisfied requirements designed to prevent discrimination in favor of the highly compensated. As a prerequisite to securing qualification, it was proposed that plans establish that discrimination would not be practiced. The Senate[13] however chose to delete the nondiscrimination requirements and the finally enacted statute makes no reference to discrimination. Employers were thereby given free reign to discriminate by restricting the personnel covered and extending the scope of offered benefits. So long as the requirements with respect to the definition of a medical payment plan are met, an employer may discriminate as it chooses and to its heart's content. For example, eligibility may be restricted to shareholder-officers and other key employees.

Nothing in the tax law forbids an employer to discriminate among employees in determining compensation. Similarly, discriminatory practices may be exercised with respect to other fringe benefits. In view of the clear statutory history and the Regulations enacted, no basis exists for an overzealous Revenue Agent to legislate his own concept about discrimination in connection with medical payment fringe benefits.

Medical Payments and Reasonableness of Compensation

The employer's deduction of medical payments is assured under the general expense sections[14] which only require that the expenses be ordinary and necessary. From the employer's vantage point these expenses are justified by their contribution to increased efficiency resulting from the enhanced physical and mental well-being of his employees.

The Regulations[15] specifically provide for the propriety of medical payment plan deductions when the benefits inure to the health and welfare of employees and their families. It is stated that amounts expended for sickness, accident, hospitalization, medical expense or similar benefit plans are deductible so long as they qualify as ordinary and necessary expenses of the trade or business.

Of course, the Commissioner may allege that the medical payments to employee-shareholders, when added to the aggregate of compensation and other fringe benefits, are unreasonably high and in essence constitute dividend distributions. Admittedly, the line is difficult to draw; however, the governing principles would be the same as are determinative in all unreasonable compensation issues involving shareholder-employees.[16]

If a status is reached where it is reasonable to expect such an attack, it behooves the employer and employee to voluntarily reduce the compensation paid, rather than jeopardize the deductibility of the medical payment and the corresponding reclassification of the receipt in the employee's hands. Where a taxpayer is a shareholder-employee of several corporations it may be possible for him to mitigate the unreasonableness issue by having the medical expense re-

imbursements spread over the corporate group.

Medical Payments vs. Wage Continuation Payments

As is true with most complex statutes, the 1954 revision probably engendered fully as many problems as it resolved. As previously illustrated, significantly different tax results for employees are arrived at depending upon the employer's characterization of the payment. This is especially true for the self-insuring employer's classification of the first $100 per week paid an employee who has met the qualifications necessary to receive wage continuation payments[17] tax free and who also is eligible to receive medical payment reimbursements. It is always preferable in such a situation for an employee to have the first $100 called wage continuation payments and the excess, if conditions permit, classified as medical payments. In this manner all of the receipts will be tax free, but to the extent that the employee's medical bills exceed his medical reimbursements, he may be able to obtain a medical deduction to offset his other taxable income.

Similar problems will also arise during the first seven days of an employee's absence (without hospitalization) from work when the employee will be better served if the reimbursement is first characterized as medical payments to the extent possible. This same classification problem will also overlap employer payments for dismemberment or disfigurement.[18]

This discussion serves to point up that the employer's classification will undoubtedly be questioned by Revenue Agents who understand what might foster the particular name given the accident and health payment. Although a reasonable administrative interpretation of the present law should be sufficient to prevent shams, continued abuses may ultimately lead to remedial legislation and cause the loss of the advantages currently enjoyed.

Other Considerations

The preferential tax exclusion treatment is granted only to employees.[19] Neither under common law concepts nor by statutory definition[20] may individual proprietors or partners qualify as employees. Therefore sole proprietors and partners may not consider medical payments as business expense; such payments are deductible exclusively under the medical expense deduction section[21] of the Code.

The question has also arisen whether medical reimbursement benefits paid by a qualified profit-sharing trust may be excluded from the income of the covered employee. The regulations[22] specifically permit such an exclusion as regards wage continuation payments, but no mention is made therein of medical expense reimbursements. Although no logical reason would seem to exist to prevent a distribution from a qualified trust from obtaining the medical payment exclusion, nevertheless, the omission to specifically resolve this question may be indicative of the Service's reluctance to acquiesce in such treatment.

The inherent tax advantage along with the national trend to use fringe benefits to augment wages will undoubtedly assure a drastic increase in the development of medical payment plans within the next decade. In this context, it would behoove practitioners to currently reappraise the position of their clients to determine the desirability of installing such a plan.

References

1. In general, the approach of this paper is to discuss non-contributory medical payment plans from a self-insuring employer's point of view. For other articles on such plans, see Pyle, "Income, Estate and Gift Taxation of Life, Accident and Sickness Insurance and Annuities Under the 1954 Code," 1956 Tulane Tax Institute Proceedings 467; Seligman, "Taxation of Sickness, Accident Benefits," 6 Jour. of Taxation 322(1955); Note, "Taxation of Employer Accident and Health Plans Before and Under the 1954 Code," 64 Yale L. Jour. 222(1954).
2. 1954 Code Section 213 permits the deduction of medical expenses in excess of 3 per cent of the taxpayer's adjusted gross income. On joint, head of household, and surviving spouse returns the deduction is limited to $2,500 for each exemption but the aggregate allowance may not exceed $10,000; on a separate return a $2,500 per exemption limitation is in effect and the maximum permissible deduction is $5.000.
3. See, Schlenger, "Disability Benefits Under Section 22(b)(5)," 40 Virginia L. Rev. 549(1954).
4. Holmes, "The Common Law" (1881), p. 1.
5. 1939 Code Section 22(b)(5).
6. 1954 Code Sections 104-106.
7. In *Haynes* v. *United States,* 57-1 USTC Par. 9536 (1957), the Supreme Court refused to limit the statutory term to the forms of insurance conventionally made available by commercial companies.
8. See note 6, supra.
9. Regulations 1.105-5.
10. 1939 Code Section 23(x) prescribed even more stringent treatment than described in successor 1954 Code Section 213; see note 2, supra.
11. See Regulations 1.105-5 which states that "A plan may cover one or more employees" but Pyle, op. cit. supra note 1, at 576, interprets this language to mean that a plan may cover only one employee, if the employer has but one employee or only one employee in the class in which the employee is a member
12. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 15, A32 (1954).
13. See Sen. Rep. No. 1622, 83d Cong., 2d Sess. 185, 15 (1954).
14. See 1954 Code Sections 162 and 212.
15. Regulations 1.162-10.
16. See Eolis, The Adequacy of Officers Salaries, 7 N. Y. Univ. Tax Instit. 39 (1949); Note, Reasonable Allowance For Salaries, 56 Harv. L. Rev. 997 (1943).
17. 1954 Code Section 105(d).
18. 1954 Code Section 105(c).
19. See Rev. Rul. 56-326.
20. 1954 Code Section 7701(a)(20).
21. Note 2, supra.
22. See Regulations 1.105-4(a)(3)(i) and and 1.402(a)-1(a)(1)(ii).

Conforming Federal and State Taxable Income

By IRA J. PALESTIN

Conformity of State and Federal taxable income is regarded as a desirable objective. Vital State fiscal considerations, however, may interpose obstacles. Involved is the right of the State to determine areas of taxation best suited to its own policy.

Annually, if not always, we hear and read taxpayer expressions of anguish at the conflict between Federal and local income tax laws. A typical criticism is published in the Letters to the Editor Department in the May 1957 issue of *The New York Certified Public Accountant.* There a correspondent laments the differences between Federal and New York State income tax laws and the time spent by accountants in reconciling taxable income for the same year on State and Federal forms. He concludes:

"Is there any reason, in short, why the State of New York cannot accept a carbon copy of the Federal return as the State return and accept a percentage of the tax paid to the Federal government as the New York tax?"

Undoubtedly his grief would be mitigated by the use of federally reported taxable income, with some adjustments, as the base in computing the State income tax.

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This article has been adapted by Commissioner Palestin from a paper presented by him at the 1957 annual conference of the National Association of Tax Administrators.

Revenue Objectives

There is logical basis for this correspondent's anguish. Issues are presented which must be met. In approaching the question of uniformity of State and Federal income tax laws, it is relevant to bear in mind the revenue objectives of each. Federal budgetary receipts for fiscal year 1956 totalled 68.1 billion dollars. Of this sum 32.2 billion dollars were supplied by personal income tax proceeds and 20.9 billion by corporation income taxes. Compare this with the budget and tax yields of the largest state in the Union, New York, where budgetary revenues for fiscal year ended March 31, 1957 totalled a modest 1.39 billion and per-

sonal income tax collections amounted to 476 million.

The Narrowing of Differences

These gigantic contrasts evidence differences not merely in numbers. Despite the differences, New York is committed to the principle of substantial income tax uniformity between it and the Federal, consistent with New York's formulation of its own State policy. The enactment of the 1954 Internal Revenue Code underscored our opportunity, if not necessity, of narrowing differences between the income tax laws of both governments. In the administration of Governor Harriman amendments of the State income tax law became effective which provided limited additional exemptions to taxpayers over the age of 65 and to those who are blind; granted taxpayers the option of using a 52-53 week taxable year; substantially conformed to the Federal, our tax treatment of support payments made pursuant to a written separation agreement not incident to a court decree in a suit between husband and wife; narrowed the differences in State and Federal deductions for medical expenses; provided a deduction within certain limits for child care expenses of working mothers or widowers; substantially conformed to the Federal treatment of gain realized on the sale of a taxpayer's principal residence, followed by his purchase or construction of a new residence; conformed to the Federal in excluding from tax death benefits up to $5,000 paid by an employer to the beneficiary or estate of his employee; prohibited as a deduction interest paid or accrued on monies borrowed to purchase single-premium life insurance contracts; required a retiring partner with a taxable year different from the copartnership's to include his distributive share of income, gains or losses in the taxable year during which his partnership interest is liquidated, instead of in his taxable year that embraces the end of the partnership's taxable period; extended to clergymen an exemption from gross income in respect of rental allowances paid to and applied by them as rent for their living quarters.

Three Bills Enacted and Vetoed

At our 1957 legislative session three bills, seeking conformity to the Federal in the extension of capital gains treatment, were enacted and vetoed. These related to: lump-sum distributions from stock bonus, pension and profit-sharing plans made within a taxable year; dividends from mutual funds that qualify as regulated investment companies, where such dividends result from the realization of capital gains under Federal law; and the exercise of restricted stock options granted to an employee by his employer. Various objections were voiced to these bills. One line of objection was their discriminatory treatment as against the general class of employees not fortunate enough to participate in bonus or profit-sharing and pension plans, and, in the case of the restricted stock option, its discrimination against the general class of employees of non-incorporated business.

With respect to mutual funds declaring dividends from their capital gains, the applicable bill did not specify all of the federally defined conditions requisite to attainment of the status of a regulated investment company. Regarding the stock option bill, an objection was raised that there were no set limits against the amount of stock which could be optioned to favored top executives. We felt that deferring of taxes until exercise of a stock option or realization of pension principal payments could be

self-defeating from the State's point of view where funds would be received by an employee upon his retirement and removal to a jurisdiction beyond the State's tax reach. In respect of this last objection, the State is at a substantial disadvantage when compared with the broad reach of the Federal government.

Also involved in consideration of these measures was the loss of revenue to the State resulting from the change to capital gains treatment. It was estimated that under existing pension plans, New York would lose approximately $500,000 annually by the change to capital gains treatment of lump-sum distributions, with much larger revenue losses in prospect because of the continuing zooming increase in new plans. The change in treatment of capital gains realized by mutual funds would cost the State approximately $850,000 in annual revenues.

Fiscal Policy and Tax Rate Structure

Such revenue contractions, and the losses that would result from similar changes encouraged in the future by the adoption of these bills, would affect a State operating on a tight budget, as does New York, which seeks the maintenance of reasonably measured income taxes. New York has a mildly progressive rate structure starting at 2% of the first $1,000 of taxable income and rising to a maximum of 7% on net income in excess of $9,000. Personal exemptions are $1,000 for a single individual, $2,500 for a married couple distributable between them at will, and $400 for each dependent. There are additional special exemptions. Our rate structure has been maintained steadily, in contrast with Federal's, since 1935. The amount of our personal exemptions has been constant since 1933. Although the inflation of the economy has resulted in an increase of State income taxpayers running into millions, and has brought about a contraction of personal exemption size in a "real dollar" sense. New York taxpayers have long been accustomed to stability in rate and in personal exemption. This is a desirable exercise and expression of State public policy. So strongly have successive administrations felt about steadily maintained rates and exemptions, that reductions in tax have been achieved when possible, not by rate-lowering, but by percentage discounts off tax. These ranged between 50% and 10% up to 1954. As a result of Governor Harriman's insistence against across-the-board reductions and in favor of discounts principally to benefit low-income earners, the last two years have seen weighted credits against tax: 15% against the first $100 of tax and 10% against the next $200.

Capital Gains Treatment

Capital gains are taxed in New York separately from normal income. The capital gain tax is at half of our normal rates; it begins at the bottom of the rate schedule. Capital losses are fully deductible from capital gains. There is no holding period requirement. Net capital losses can be carried forward five years for application against net capital gains.

Our capital gains provisions have been constant since 1937. They supply a substantially favorable tax treatment. Reporting gains and losses, and calculating this separate tax, are simple. And the inapplicability of net capital loss against any part of normal income operates as a stabilizer of State income tax revenues.

Contrast the Federal income tax law with our own. It is almost unnecessary to say that the steeply graduated Federal rate structure, reaching a maximum of

91% has made inevitable a wide congeries of transactions to which capital gains treatment, instead of the normal tax, has been extended under Federal law. Whether this joinder of a high rate progressivity to an area of capital gain that constantly expands under a 25% rate top is socially desirable I need not discuss. But the compelling reasons for mitigation of a mountainous rate structure do not exist in the State of New York.

Not only is the area of capital gains limited in New York and its reporting simple, but there are relatively few taxpayers in a position to benefit from slavish conformity of our capital gains law to the Federal. The latest analysis of our personal income tax returns relates to those filed in 1955. This shows that 66% of our collections of normal tax was derived from wages and salaries. Of the normal-tax collection, 20% was supplied by business and trust income and 12% from dividends and interest. Wages and salaries constituted 81% of total income, as contrasted with 12% for business and trust income and 6% for income from dividends and interest. Of our 3,800,000 taxpayers for income year 1954, 73% earned net income less than $5,000; 88.5% of the taxpayers earned net income less than $7,000.

These figures do not permit precise conclusions. But they do sufficiently indicate that among the vast mass of State income taxpayers it is a small minority only that stands to benefit from the narrowing of capital gains differences between the State and Federal law.

State Policy—Independence vs. Conformity

Proposals that the State income tax be a percentage supplement to the Federal, or that net taxable income as reported to Federal be used, with minor adjustments, for State purposes are supported as not contravening State autonomy on the ground that rates and exemption amounts are within the power of the State to determine. Indeed it is conceded in this school of thought that the automatic following of the Federal yield or tax base will necessarily involve changes in state-imposed rates and exemptions as future Congresses will amend the Internal Revenue Code. This raises a fundamental issue for determination by the individual states. In New York, should State policy call for continued maintenance of a tax structure rising gently above liberal exemptions to a modest top of 7%; or should this structure be changed with a frequency beyond the State's control in order fully to dissolve the reporting inconvenience of a minority of its taxpayers? Obviously the State should decide for itself what revenue system will finance its own State needs with a minimum of inequity, it being traditionally difficult to devise any system of taxation that will mete full equity literally to all.

That New York should continue free to devise its own tax system has been indirectly advocated by one of the prominent business taxpayers' associations of our State. This group has frequently recommended a close conformity between the Federal and State income tax laws.[1] Yet it has recently urged the adoption in New York of an amendment allowing exclusions and deductions within limits from gross income for the establishment of private pension plans for self-employed individuals. Bills to this effect have been before the Congress for at least three years. It was urged that New York's pioneering in this field might result in eventual uniformity resulting from the good example we could thereby set the Federal government.

The homage thus indirectly paid to the proposition that the State be free to determine for itself what its tax policy should be has much authority to support

it. See page 104 of the June 1955 report by the Commission on Intergovernmental Relations and page 122 of "The Federal Revenue System: Facts and Problems," released in November 1955 by the Mills Sub-Committee of the Joint Committee on the Economic Report.

It is interesting to observe that there are only four states of the Union (thirty-one states have a personal income tax) which relate their base of net taxable income to that reported federally. They are Vermont, Iowa, Montana and Kentucky. The Territory of Alaska employs a local tax supplement to the Federal tax. New Mexico and Utah recently terminated a short-lived provision giving State taxpayers an option of determining their income tax as a percentage of income taxes federally reported.

The Corporation Franchise Tax

This discussion should not be completed without reference to the income base for the determination of franchise tax of New York business corporations. Our law states that total corporate net income ". . . shall be presumably the same as entire net income which the taxpayer is required to report to the United States Treasury Department . . .," with certain exceptions. New York's experience with this law since 1917 has been satisfactory. But we have 149,000 business corporations reporting in 1955, the last year of our statistical analysis. Compare this with the approximately 4,-000,000 New York personal income taxpayers for that year. These corporations paid us $159,000,000, i.e., approximately one-third of the total income tax yield.

Included in this relatively small number of corporate taxpayers are some 50% which pay a $25 minimum franchise tax. Another 26,000 corporations, i.e., 17.3%, pay less than $100 in franchise taxes. The most significant group within these corporate taxpayers, some 1,700 of them, pay franchise taxes in excess of $10,000. The yield from them is 70% of total franchise tax receipts. These large taxpayers include the world's giant corporations whose accounts are subject to "automatic audit" by the Internal Revenue Service. I don't know precisely what this term means, but I suspect such audits are performed by treasury representatives who are virtually resident at the accounts office of these corporations. Against their painstaking audits, our independent audits would be superfluous.

When it is remembered that corporate accounts in general are more complicated than individuals', presenting more complex problems of audit, it will be seen that a State-Federal tie is feasible in the case of the business corporation tax. Federal audits of corporation income tax returns are more numerous than those of personal returns. The use of the Federal tax base in measuring the corporation franchise tax has not dispensed with corporate audits by New York State but it has saved us considerable auditing problems, administrative expenditure and staff.

Conclusion

In the interest of taxpayer convenience, and of coordination and economy in administration, close conformity between State and Federal income tax laws is desirable. Conformity can be achieved principally by State action taken as a part of its overall State policy. Where the State determines for itself an independent area of income taxation, that should be set and administered as simply as possible. The opposing values of uniformity and of the unfettered right of a State to determine its own policy are not always reconcilable. This area of potential conflict or of mutual inspiration is a characteristic of the Federal system upon which our nation and State have built enduring values.

Official Release

Cost, Expense and Loss

Issued July 1957 as Accounting Terminology Bulletin No. 4 by the Committee on Terminology, American Institute of Certified Public Accountants.

Introduction

1. In Accounting Terminology Bulletin No. 2 the terms proceeds, revenue, income, profit, and earnings were defined. This bulletin defines the correlative terms *cost, expense,* and *loss.* While ascertainment of cost sometimes involves processes of valuation and allocation, the techniques of ascertainment are not discussed here.

Definitions

2. *Cost* is the amount, measured in money, of cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services received or to be received. Costs can be classified as unexpired or expired. Unexpired costs (assets) are those which are applicable to the production of future revenues. Examples of such unexpired costs are inventories, prepaid expenses, plant, investments, and deferred charges. Expired costs are those which are not applicable to the production of future revenues, and for that reason are treated as deductions from current revenues or are charged against retained earnings. Examples of such expired costs are costs of products or other assets sold or disposed of, and current expenses. Unexpired costs may be transferred from one classification to another before becoming expired costs as above defined, e.g., depreciation or insurance on plant may be included in unexpired costs ascribed to inventories.

3. *Expense* in its broadest sense includes all expired costs which are deductible from revenues. In income statements, distinctions are often made between various types of expired costs by captions or titles including such terms as cost, expense, or loss, e.g., cost of goods or services sold, operating expenses, selling and administrative expenses, and loss on sale of property. These distinctions seem generally useful, and indicate that the narrower use of the term *expense* refers to such items as operating, selling or administrative expenses, interest, and taxes.

4. *Loss* is (1) the excess of all expenses, in the broad sense of that word, over revenues for a period, or (2) the excess of all or the appropriate portion of the cost of assets over related proceeds, if any, when the items are sold, abandoned, or either wholly or partially destroyed by casualty or otherwise written off. When losses such as those described in (2) above are deducted from revenues, they are expenses in the broad sense of that term.

Recommendations

5. The term *cost* should be used when appropriate in describing the basis of assets as displayed in balance sheets, and properly should be used in income statements to describe such items as cost of goods sold, or costs of other properties or investments sold or abandoned.

6. While the term *expense* is useful in its broad and generic sense in discussions of transactions and as a general caption in income statements, its use in financial statements is often appropriately limited to the narrower sense of the term as indicated in paragraph 3. In any event, items entering into the computation of cost of manufacturing, such as material, labor, and overhead, should be described as costs and not as expenses.

7. The term *loss* should be used in financial statements in reference to net or partially net results when appropriate in place of the term income or profit as described in paragraphs 8, 9, and 10 of Accounting Terminology Bulletin No. 2. In such cases the term should generally be used with appropriate qualifying adjectives. It should also be used in describing results of specific transactions, generally those that deal with disposition of assets. The use of the term in the latter type of cases is believed desirable since it distinguishes them from more normal expenses of a recurring type which are generally shown in gross amounts.

Responsibilities of a Bank Director

Broadly speaking, the major responsibilities of a director include the direction and control of officers and personnel; the establishment of over-all policy on loans, investments, dividends, and types of services to be rendered; the establishment of physical facilities and their expansion; a review of the profitableness of the institution; and, perhaps most important of all, the provision of internal, and, when necessary, external examinations and audits.

An efficient way of dealing with these tasks is to set up a specific procedure for board meetings. On these occasions, the executive officers should provide statements of the bank's condition and an analysis of its assets and liabilities; a review of its securities sales and purchases; a review of the over-all loan and investment policy; an opportunity for individual discussion of larger loans, overdue items, and loans to officers; an analysis of earnings, expenses, and dividends; and a summary of internal and external audits. One further item is essential—the findings of each bank examination should be presented to the board, at its first meeting subsequent to the receipt of the report, along with all important correspondence with the supervisory authorities.

THE BANK DIRECTOR'S RESPONSIBILITY,
Superintendent of Banks, State of New York, 1957

Highlights In Current Financial Reporting

By J. SINCLAIR ARMSTRONG

The former chairman of the SEC presents his personal views on several recent major accounting and financial developments involving the SEC, and of vital importance to the accounting profession and business enterprise.

It is a great pleasure for me, as a Chicago lawyer who has practiced in the field of corporation law and finance and has served for two years as Chairman and four years as a member of the Securities and Exchange Commission, to have an opportunity to discuss "Highlights in Current Financial Reporting." The observations I am about to make were written at a time when I was Chairman of the Commission, but as presented here I speak not for the Commission. I will express my own views and these may not necessarily reflect the views of the Commission, and, as must be obvious, they have not been submitted to or reviewed or approved by the Navy Department.

I will discuss a number of topics which may appear more or less unrelated, but which are all vitally important to the accounting profession and to the continued development by the profession and the Commission, working in cooperation and harmony, of high accounting and auditing standards in the United States. This in turn is vitally important to our free enterprise system in which our productive facilities in this country are owned, through the medium of corporate securities, by the investing public.

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This article has been adapted by the author from a paper presented by him before the 1957 annual meeting of the Illinois Society of CPAs.

Audits of Brokers and Dealers in Securities

First, I will consider certain developments with regard to audits of brokers and dealers in securities. The statement of financial condition required of certain brokers or dealers who file reports with the Commission on the annual reporting form for brokers and dealers[1] is required to be certified by an independent public or certified public accountant. The Commission's rules prescribe what are referred to as "Minimum Audit Requirements." These requirements are practically identical with the minimum requirements of the New York Stock Exchange.

The difficulties experienced by the Commission's staff over the years in obtaining properly prepared statements of financial condition of registered broker-dealer firms and the number of

defalcations in such firms have demonstrated a need for a more specific guide for the auditing of these firms. The auditing of broker-dealers is a very limited and specialized field of accounting and auditing in which there is little authoritative literature. The staff found in examining these reports that many accountants were simply not familiar with the brokerage business and brokerage accounting and auditing. The processing of the reports also indicated that the accountants were inclined to regard the minimum requirements as a complete audit program and failed to vary or supplement the auditing procedures as appropriate under the circumstances of the audit.

From time to time the Commission's staff discussed with representatives of the accounting profession ways and means of alleviating the situation. In 1951 the staff suggested to the Committee on Relations with the Securities and Exchange Commission of the American Institute of Accountants that a brokerage audit case study be prepared. This suggestion was followed and a case study prepared by a member of the Committee was submitted to our staff in August 1952. It developed that the problem was larger than could be covered in a case study based on current practice. It involved rather the delineation and extension of procedures deemed necessary and appropriate in an audit made for the purpose of safeguarding the securities and funds of customers and to discourage, if not forestall, defalcation. This larger assignment was undertaken and assigned to a special subcommittee of the Institute's Committee on Auditing Procedure, composed of representatives of six leading accounting firms.

Facts covering various problems encountered by our staff, after a review of 4,000 filings, were furnished to the subcommittee. From time to time representatives of our staff and the New York Stock Exchange commented and made suggestions on preliminary drafts. Finally, in October 1956 the American Institute of Accountants published the booklet, "Audits of Brokers or Dealers in Securities." This booklet is concerned with the operation of brokerage concerns. It describes the special accounting records used and suggests auditing procedures and forms of reports for the audit of brokerage concerns. While this booklet may not be a final solution of the problem, it does represent a long, forward step.

Early in the process of drafting forms to obtain fair disclosure of financial facts and accounting information, the Commission adopted the policy of prescribing the forms' content and extent of detail required, but leaving the form, order and terminology to the discretion of the registrant within the framework of generally accepted accounting principles, practices and procedures. In auditing, the Commission initially relied upon the independent accountant for assuming the responsibility for the adequacy of the audit under generally accepted auditing standards. Over the years the Commission has worked with the accounting profession, industry, and the financial community in evolving better standards of auditing and financial reporting. An exception to this policy, and one which looks in the direction of codification of auditing standards by the regulatory agency, was the adoption by the Commission of the "Minimum Audit Requirements" pursuant to our reporting requirements for brokers and dealers in securities.[2]

In the discussion with the Institute committee, our Chief Accountant[3] suggested that if a comprehensive program

covering the audit of broker-dealers, rather than a case study, was prepared which would include detailed instructions for examining the system of internal checks, or the lack of checks, with a view to safeguarding the securities and funds of customers, and which would discourage if not forestall defalcations, were adopted, consideration would be given to the elimination of the minimum audit requirement from the rules. This suggestion was in line with our policy of relying upon established auditing standards. The recommendation that the minimum audit requirement be eliminated was made to the Commission. However, at the present time the Commission is waiting to see what influence the booklet has on brokerage auditing practice, and is considering the advisability of this recommendation.

Consideration of this booklet has again brought into relief the fiduciary nature of the brokerage business and the fact that certified statements are required, in compliance with the intent of the Congress expressed in the statutes, in order to safeguard the securities and funds of customers rather than to protect the owners of the business. This purpose entails care and responsibility beyond that of the ordinary industrial audit. My opinion is that the Commission should not rescind the minimum audit requirements. If it does, it will thereby remove the specific provisions which look to the safeguarding of customers' securities and funds and will lend support to the argument that industrial auditing standards are sufficient.

Foreign Accounting and Auditing

Second, I will discuss developments with respect to foreign accounting and auditing. The Securities Act of 1933 provides for the filing of balance sheets and profit and loss statements in such form and detail as the Commission prescribes[4], certified by an independent public or certified accountant. The Act specifies the information required to be included in a registration statement and gives the Commission considerable latitude to expand or modify the information requirements of the Act as they apply to problems presented by particular classes of issuers or securities.[5]

An instruction as to financial statements which provides for the filing of other statements in certain cases[6] is written under this authority, and has been relied upon in many instances, to permit the Commission to substitute, increase or omit the financial statement disclosures specified in the form when necessary or appropriate to an adequate and fair presentation of a particular financial problem. The Securities Exchange Act of 1934[7] and the Investment Company Act of 1940[8] have substantially the same financial and certification requirements.

The statutes by their terms make no distinction between domestic private issuers and foreign private issuers. The statutes likewise make no distinction between domestic accounting firms and foreign accounting firms. There is nothing in the Congressional debates or Committee reports on the Acts to indicate that the acceptability of certificates of foreign accountants was ever considered. The statutes merely use the term "independent public or certified public accountant."

However, if a foreign private issuer, other than a North American or Cuban issuer, registers securities under the Securities Act, which requires certification, and the undertaking to continue to file annual and interim reports under the Exchange Act is operative, as in

most cases it is[9], the issuer is required to file such supplementary and periodic information, documents and reports as may be required by the Exchange Act.[10] As our regulations have been construed, foreign issuers filing annual reports under them need not follow our accounting rules in preparing financial statements unless the issuer, at the same time or subsequently, lists its securities on a national securities exchange and furnishes to the exchange financial statements complying with the Commission's accounting regulations.

This situation comes about because in 1934, when the Commission began drafting its forms for registration under the Exchange Act, it was faced with the situation that a number of foreign private issues of securities had been distributed in the United States and were listed and traded on exchanges. The Commission had no authority over these issuers except to delist the securities from national securities exchanges. The Commission prescribed that the required financial statements give at least the amount of detail as that previously given in financial statements filed with any securities exchange in the United States, or, if no such filing had been made, the amount of detail which had been given in statements made available to security holders of the issuer.

Since certification by foreign issuers has not been required under the Exchange Act, the problems under that Act have been confined largely to dealing with certification of foreign subsidiaries of domestic companies. In most instances such companies represented a minor portion of the assets and income of the business. In the early days of the administration of the Acts by the Commission, there was found to be great variety in the quality of the reports of such foreign subsidiaries. Each situation has been dealt with by the staff on an individual basis. It has been the Commission's policy to encourage foreign accountants to follow American standards of auditing and accounting with respect to statements filed under the Exchange Act. With respect to the United Kingdom and Holland, we believe that we have had considerable success. The American accountants, who are the principal accountants in these situations, have also been of great help in obtaining better reports.

With respect to statements filed by foreign issuers under the Securities Act, the Investment Company Act and on the reporting form for brokers and dealers under the Exchange Act, it has been the Commission's policy to require that American standards of auditing and financial reporting be followed. The greater portion of such filings have been made by Canadian companies. Until recent years the problem has not been of great importance and the staff has been generally successful in its endeavor to obtain compliance with American standards.

It is clear that the Congress intended that the foreign private issuer should meet the same standards of disclosure as the domestic private issuer if the foreign private issuer seeks to raise capital in the American markets. The desirability of encouraging American investments abroad, which has been encouraged by some, is not so great that the encouragement of foreign investments should be made at the cost of lowering these standards.

While the Commission has followed the practice of insisting upon substantial compliance by the foreign private issuer with the disclosure requirements applicable to the domestic issuer in connection with the registration of securities under the Securities Act, there

have been a few instances in which the Commission has accepted registrations by a foreign private issuer in which there were some variations from American practices, either in auditing procedures or in the application of accounting principles. [11] These variations have met with a mixed reception in this country, being criticized by some members of the accounting profession and accepted by others as reflecting a reasonable and practicable solution to the particular financial problem.[12]

In a recent case of a foreign company registering its outstanding stock under the Exchange Act and listing the stock for trading on a national securities exchange, the staff refused to accept the certificate of the company's auditors because they were not in fact independent by our standards and the auditing procedures followed, particularly with respect to accounts receivable and inventories, did not meet our standards.

In December 1956, we promulgated for public comment under the Administrative Procedure Act a notice of proposed amendment to the general registration form[13] regarding rights offerings by certain foreign private issuers.[14] The proposal would have relaxed the certification requirements with respect to pro-rata offerings by foreign issuers to their stockholders of securities of the same class as those registered on a national securities exchange, where the offering price was not more than 60% of the market value and the amount offered to stockholders in the United States did not exceed 5% of the total offering, and where the issuer had been in business more than 25 years and had total assets of at least $100 million or its equivalent.

The issues involved concerned the rules of the Commission under the Securities Act and not the status of private issuers. We deemed it necessary for the proponents of the revision to establish to the Commission's satisfaction that there was an overriding public interest in relaxing the requirements. Of particular concern to us was that no physical verification of inventories or confirmation of accounts receivable conforming to American auditing standards would be assured, and this startled some old ghosts in the Commission yard.[15] The public response to this proposal demonstrated, to the contrary, that there was a strong opposition to setting up, even in this limited area, a different standard for foreign reporting, and the proposal was withdrawn.[16]

In the United States, corporate securities are widely held and our capital market is the largest in the world. Investors who place their savings at the disposal of industry in new issues of corporate securities are entitled to rely on the accounting rules developed by the Commission over nearly a quarter of a century and the principles and practices developed by the American accounting profession. Any failure to require financial statements of foreign corporations registering new issues of securities for sale to the American investing public to be certified by independent auditors in accordance with the standards applicable to American corporations would establish a double standard for reporting by domestic and foreign issuers. Such statements could also be misleading because the public, other than financial experts, might have the impression that American standards had been adhered to simply because the financial statements had been filed with the Commission in a registration statement under the Securities Act.

The staff has been directed to consider whether the Commission's forms should be revised to require foreign private issuers filing new registration statements under the Securities Ex-

change Act to meet the accounting and certification requirements of the Commission's regulations.[17] As a matter of principle, I believe that any relaxation of the standards which the Commission has built up over the years under the Federal securities laws merely to accommodate the raising of capital by foreign corporations from public investors in this country would be most unwise.

It also is my view that when a business organization reaches the size where it operates in and sells its securities in several countries, it should have its accounts audited by an international firm of accountants which also practices in those countries and has firsthand knowledge of the business, accounting and financial reporting practices of those countries. It is my belief that in our own national interest and the interest of American investors, and the interest of the American accounting profession to which the success of the capital markets owes so much, the Commission should require, in statements filed with it, such companies to adhere to our auditing, certification and financial reporting standards.

This problem has been dealt with in part by the Commission under the Investment Company Act.[18] Our rules prescribe the specification of conditions and arrangements for Canadian management investment companies requesting an order permitting registration. The rule under the Investment Company Act provides that the applicant will appoint an accountant, qualified to act as an independent public accountant, who maintains a permanent office and place of business in the United States.

Insurance Companies and the SEC

Third, I will consider the so-called Fulbright Bill. The Securities and Exchange Commission is currently interested in reports to stockholders in connection with S. 1168, a bill introduced by Senator J. W. Fulbright, Chairman of the Committee on Banking and Currency, on February 11, 1957. This bill would extend the reporting, proxy and insider-trading provisions of the Exchange Act to certain large publicly-held corporations in which there is a large public interest but the securities of which are not listed on a stock exchange. The Commission believes that the broad principles and objectives of S. 1168 are sound. The Commission supports them.

S. 1168 with one exception is identical with the Committee Print dated August 5, 1955, of S. 2054, 84th Congress, originally introduced by Senator Fulbright and which was on that date favorably reported to the Committee by the Subcommittee on Securities. The exception is that the exemption for insurance corporations contained in that Committee Print does not appear in S. 1168.

The Commission made a factual study of the financial reporting and proxy soliciting practices of those corporations which would come within the scope of S. 2054 (as amended to exempt insurance companies from the bill's coverage) and the trading practices of officers, directors, and 10% stockholders of a sampling of such corporations. On May 17, 1956, we submitted to the Committee our report setting forth the results of that study.[19] Our study indicated that the bill (as amended to exclude insurance companies) would apply to approximately 1,200 corporations with total assets of about $35 billion. Thereafter, on June 22, 1956, during the hearing before the Committee on the bill, the Commission was requested by Senator Fulbright to make a further study of those insurance companies which would come within

the provisions of the amended bill if the specific exemption for insurance companies should be removed.[20] On February 6, 1957, a supplementary report setting forth the results of this further study was submitted to the Committee.[21]

In our letter of February 6, 1957, transmitting to the Committee the supplementary report of the Commission, we stated that, on the basis of our study of financial reporting and proxy soliciting practices of the 169 insurance companies which would be subject to the bill if the exemption should be deleted and the bill enacted, the Commission was of the opinion that it would be consistent with the purposes of the Federal securities laws and of S. 2054, 84th Congress, that the exemption be deleted and the bill passed (subject to two other suggestions for amendment not related to financial reporting which had been made by the Commission). Subject to the suggested revisions the Commission believes that enactment of the bill would provide important additional protection to investors, that its effect upon the capital markets of the country would be favorable and that it would not unreasonably burden corporations subject to its provisions. In expressing this view, we limited ourselves to a consideration of the Congressional purposes expressed in the Federal securities laws and did not express views as to any other areas of Federal or State regulation of the insurance industry.

The Commission's supplementary report indicated that 169 insurance corporations, having total assets of approximately $24 billion, will be subject to the bill. Of these, 44, having total assets of approximately $5 billion, are now required to file reports pursuant to Section 15(d) of the Act, and 125, having total assets of approximately $19 billion, which do not now report would become obligated to do so.

The Commission's staff examined the reports to stockholders of 161 of these insurance corporations in the light of generally accepted accounting principles and standards of fair disclosure. It was found that 61 of the 161 insurance corporations gave only a balance sheet often with little detailed classification of assets and liabilities. Of the 117 reports to stockholders of corporations not presently required to file reports with the Commission, 63% were materially deficient in that they omitted to furnish a profit and loss statement, a surplus statement, or both, or the statements were so brief as to be inadequate. On the other hand, of the 44 reports to stockholders of insurance corporations subject to the bill which are presently required to file financial data with the Commission pursuant to Section 15(d), 30% were so deficient. The comparable percentages for the first study, which did not include insurance companies, were 21% and 4%, respectively. The over-all percentages for materially deficient reports were 54% for insurance companies and 13% for other companies.

The more significant finding, however, is the fact that only 6% of the insurance corporations attempted to give the additional information required by the Commission's accounting regulation [22] and sound accounting principles and practice in order to make the financial statements of insurance companies comparable to other companies. This information is necessary to an understanding of the financial statements and to proper financial analysis.

With respect to the evaluation of proxy soliciting material of insurance corporations studied, we found that this material likewise suffered by comparison with that of the other corporations

in the first study.[23] As Chairman of the Commission, I testified again on behalf of the Commission before the Subcommittee on Securities of the Committee on Banking and Currency on May 21, 1957, and reaffirmed our previous position that the broad principles and objectives of the bill are sound and that the Commission supports them, and stated that the Commission is of the opinion that it would be consistent with the purpose of the Federal securities laws and of the proposed bill that the insurance companies exemption be deleted and the bill passed, subject to the two suggestions for amendments which have been made by the Commission.

I also stated on behalf of the Commission that the legislation would provide additional protection to investors in corporate securities in which there is broad public investor interest and which are sold and traded in the interstate securities market by requiring disclosure of the business and financial facts pertaining to the corporation issuing them, and would strengthen the protections against fraud afforded to investors. Furthermore, it is believed that the effect of the bill, if modified in accordance with our suggestions, on the integrity of the capital markets of the country would be favorable, both from the standpoint of the trading in the over-the-counter and exchange markets and the markets for the raising of new capital.

Finally, we do not believe that the duties which the bill would place upon such corporations would be unreasonably burdensome; it has not proven so in the case of listed corporations. Furthermore, the requirements of the securities acts have a tendency to cause corporations subject to them to reexamine their financial policies and practices and often have the salutary effect of the institution of sounder policies and practices by such corporations.

At the hearing before the Subcommittee, Senator Prescott Bush made two well-taken points, that there has been no public demand for inclusion of insurance companies in the coverage of the bill and that its administration would require at least a $500,000 increase in the Commission's annual appropriation. I testified, in the light of the cut of $478,000 made by the House of Representatives in the Independent Offices Appropriation Bill in the provision of $7,178,000 for the Commission's operation in fiscal 1958 made in the President's Budget (one third of which is reimbursed to the Treasury in statutory fees), that I would rather see the Congress provide $500,000 annually for administration of the Commission's existing statutory responsibilities, including particularly anti-fraud work, than impose new statutory responsibilities. However, as this was given in a colloquy at the hearing, it was an expression of my own views in answer to a question not earlier considered and my answer does not represent a position taken by the Commission. The Commission staff today is at 65% of its 1947 strength and is less than its 1953 strength, but its volume of work is about triple that of 10 years ago and is at an all-time high.

On July 24, 1957, the Committee on Banking and Currency favorably reported to the Senate an amended S. 1168. Under the amendments adopted by the Committee, the bill would require only about 650, rather than 1,370, large unlisted corporations to comply with its provisions. The amended bill is made specifically inapplicable to any security issued by a State-supervised insurance corporation.[23a]

The "No Sale" Rule

Fourth, I will discuss the Commission's problem with our so-called "No

Sale" rule.[24] The application of the registration requirements of the Securities Act to mergers, consolidations, recapitalizations and sales of corporate assets in consideration for securities of another corporation, presents practical and legal problems which have been of increasing concern to the Commission. Typically, in these situations, a corporation will issue securities, often in large quantities, either to the stockholders of another corporation the assets of which are being acquired either by merger or by sale of assets, or to its own stockholders in connection with a recapitalization. The transactions are effectuated pursuant to a vote of stockholders of one or both of the participating corporations in accordance with state law. The question immediately arises whether the securities so issued must be registered under the Securities Act.

Early in the Commission's history, the position was taken as a matter of interpretation that for the purposes of the registration requirements of the Act, at least, no "offer" or "sale" of a security was deemed to be involved so far as stockholders of a corporation were concerned, where proposals of this character were submitted to them for a vote. This concept—familiarly known as the "no sale" theory—is embodied in Commission Rule 133 under the Securities Act.[25] This theory and rule disposed of many serious practical and legal problems, both for the Commission and for corporations contemplating such transactions. At the same time, however, its practical effect was to exempt, or exclude, from the registration requirements of the Securities Act a large number of cases in which securities were in fact distributed by issuers to the investing public.

Recent events have forced the Commission to reconsider the soundness of this doctrine. For example, the Commission's opinion and order withdrawing the registration on the American Stock Exchange of the capital stock of Great Sweet Grass Oils Limited and Kroy Oils Limited[26] describes a deliberately calculated scheme to dispose of millions of shares of highly speculative stock to the investing public without any of the disclosures which would be called for by registration, and to divert most of the proceeds to insiders rather than to productive use. The Commission found that Rule 133 had no application to these transactions, for several reasons. In the first place, the exchange of assets was merely a step in a pre-existing plan for distributing the securities through underwriters to the investing public.[27] Rule 133 may provide an exemption insofar as stockholders are concerned, but it does not mean that subsequent sales of the stock so issued are necessarily exempt from registration. Some other exemption must be found for such subsequent sales, such as the exemption available under Section 4(1) for casual sales by non-controlling stockholders. That exemption, of course, is not applicable to a distribution through underwriters, such as occurred here. In any event, these transactions were not corporate action in any real sense, since the persons negotiating the transactions had sufficient control of the voting stock to make the vote a mere formality.

Reliance in the Great Sweet Grass and Kroy Oils cases and similar transactions on Rule 133 represented, of course, a misapplication of the "no sale" theory. Beyond that, however, the basic question of whether the rule is consistent with the statutory phraseology and purpose must be faced, and the Commission's difficulties in the proper enforcement of the law illustrated by these cases point up the importance of this question. This really resolves itself into two questions: first, whether the Com-

mission has authority to adopt a rule of this character, and secondly, whether the particular rule is sound.

Section 19(a) of the Securities Act grants to the Commission broad rule-making power, as follows:

"The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical and trade terms used in this title."

Rules under this section may be of several types. There may be what could be called "substantive rules" prescribing the procedures to be followed and the requirements to be observed in connection with registration and other matters. There may be "defining rules," which define accounting, technical and trade terms. And finally there may be interpretive rules.

The first two classes of rules—the substantive and defining—become in effect a part of the law since they represent an exercise of a rule-making power expressly granted by the Congress to the Commission, and such rules, in effect, supplement the statute. Interpretive rules rest on a slightly different foundation. The Commission must necessarily interpret the statute in order to perform its duties, and rules embodying such interpretations may therefore become necessary in order for the Commission to carry out the provisions of the Acts.[28] Rule 133 is of this character. Upon its adoption in 1951, the Commission classified it as an interpretive rule for the purposes of the Administrative Procedure Act, which specifies that the procedure of public notice and comment provided for in Sections 4(a) and 4(b) thereof shall not be applicable to interpretative rules except as otherwise required by law. In addition, the rule on its face clearly appears to be an interpretation of the statute.[29]

Considered as an interpretive rule it next becomes necessary to determine whether the rule is a correct interpretation. In my view it is not. The declaration which it contains that certain transactions therein specified do not involve an offer or sale seems hard to reconcile with the statutory definitions of these terms. The terms "offer" and "sale" are specifically defined to include every contract of sale or disposition of a security for value, and every attempt to dispose of a security for value.[30] That definition in my opinion applies to the solicitation of stockholders' votes for a plan of merger or like transaction which will involve the issuance or exchange of securities for value and the solicitation of such votes in my opinion is an "attempt . . . to dispose of . . . a security or interest in a security for value."

Moreover, in Section 3(a)(9) of the Act, the Congress expressly exempted exchanges by an issuer with its existing security holders where no remuneration is paid and in Section 3(a)(10) the Congress expressly exempted securities issued in exchange for outstanding securities, claims or property interests where the transaction has court approval. Rule 133 cuts a broad swathe across both of these express exemptions, operating to exclude from the coverage of the registration provisions of the Act securities issued in exchanges or in reorganizations despite the fact that the conditions provided by the Congress for such exemptions are not satisfied and, to this extent, it is inconsistent with the statute. Rule 133 does not purport to exempt from the antifraud provisions,[31] and here, too, the Congress showed itself capable of stating what exemptions it intended and

what it did not, as it specifically exempted a number of classes of securities from the registration but not the anti-fraud provisions.[32] Moreover, the legislative history of Section 3(a)(10) shows that Congress contemplated that mergers, consolidations and reorganizations without judicial supervision should be subject to registration, a result directly contrary to that reached under Rule 133.[33]

Rule 133 has the practical effect of adding a substantial category of transactions to those expressly exempted from the registration requirements. This is obviously unsound as a matter of statutory construction. The Congress did not give any power to the Commission to add to the classes of securities exempted by the Act except in the narrow area of issues the amount of which is "small", and the character of the public offering of which is "limited." Here, the Congress gave the Commission the power to prescribe classes of securities which might be exempted on a finding by the Commission that enforcement of the registration provisions with respect to such classes of securities "is not necessary in the public interest and for the protection of investors." The exemption granted by the Commission is subject to such rules and regulations and terms and conditions as the Commission may prescribe. Originally, the maximum amount of securities that could be exempted under this provision was $100,000, which was enlarged to $300,000 by an amendment to the Act in 1945.[34]

By concluding that Rule 133 is an unsound interpretation of the Act and that the Commission is under a duty to rescind it, I do not mean for a moment to suggest that an unreasonable additional burden will be placed upon corporations which are presently furnishing to their security holders the necessary information in connection with mergers, consolidations, reclassifications or transfers of assets. Rather, I believe that by developing a few variations in its present forms for registration under the Securities Act the Commission can adapt the material which is presently filed by corporations subject to the proxy rules under the Exchange Act to registration under the Securities Act and that this can be accomplished without any unnecessary or undue burden. True it is that the existing registration procedures were not designed with reference to the problems presented where stockholder consent to mergers, consolidations, reclassifications or transfers of assets is sought. But this is only because under Rule 133 registration has not been required, and there is no reason why registration forms cannot be developed for these purposes, which would put into effect procedures consistent with the statute.

In the case of a merger or a consolidation, procedures could be devised under which the proxy statement required of listed corporations under the statute when soliciting proxies or consents could be made to serve in effect as a registration statement under the Securities Act. In case the securities issued in the transaction were to be redistributed to the public, such a proxy statement with appropriate supplements might be used as the prospectus to be delivered to persons to whom the securities were offered in such redistribution.

Reclassifications of securities would probably often be exempt under Section 3(a)(9) as an exchange by an issuer with its own security holders, assuming that paid solicitors were not used, and in other cases where such a reclassification involved no material change in the rights of any security holders, it could perhaps be argued that security holders were not being asked to give up any value and that accordingly there was no sale. This, for ex-

ample, would certainly be true of the ordinary stock split or stock dividend. Where these exemptions were not available, the proxy statement could be employed as in the case of a merger or consolidation. The issue of securities in consideration for a transfer of corporate assets would present certain technical problems, but these do not appear to be a fatal objection to the employment, where necessary, of the same techniques suggested for the other categories of transactions.

In these circumstances there would not be any substantial additional burden on issuing corporations where these corporations were already subject to the proxy rules of the Commission, and corporations which are not presently subject to the proxy rules ought to be under a duty at least to furnish something resembling a proxy statement to the stockholders whose approval they solicit. This result is clearly consistent with the underlying purpose of the Securities Act—that investors, including stockholders, should not be solicited to acquire securities for value without disclosure to them of material facts concerning the enterprise in which they are asked to invest.

The Commission traditionally, and particularly since the enactment of the Administrative Procedure Act of 1946, has given full and ample opportunity for persons affected by its rules and regulations to present their views and participate in the rule-making function. Both corporations affected by proposed rules, their counsel, and investors and their representatives can thus give us the benefit of their experience and judgment. Investors have only recently had any substantial organized representation. Securities analysts societies have recently been taking part in the rule-making process and we welcome their participation. Public hearings have been held on the problem of Rule 133. Taking into consideration the legal problems involved, we have also engaged in correspondence and conferences with representatives of the American Bar Association and the Association of the Bar of the City of New York, and the Commission is available for any suggestions or comments which they and other professional and industry representatives may submit for the purpose of working out feasible procedures or statutory amendments to deal with this problem. But the Commission has not indicated, and I hope the Commission will never indicate, any desire to participate in amending its rules or in recommending any legislative amendment to the Congress that would weaken or water down the registration provisions of the Act which I believe to be so vital to the public investor and the integrity of the capital markets in connection with the sale to the public of new issues of corporate securities.

One of the dangers which in the comments submitted to the Commission by lawyers and industry organizations on this problem appears to be generally unrecognized is the question of the legal position in which corporations and their directors and officers would find themselves in the event that a court, rather than the Commission, should hold Rule 133 invalid. Years ago the Court of Appeals for the Ninth Circuit "without going into the matter" indicated approbation of the rule,[35] but I wonder in the light of the application of the rule in the intervening years, particularly considering the recent abuses, and in the light of a full and careful legal analysis of the statutory foundation for the rule, whether a United States Court of Appeals today, or the Supreme Court of the United States, would stand for this doubtful construction of the basic statute intended by Congress for the protection of public investors.

Indeed, my premonitions in this regard are fortified by the position taken by the spokesman for the Association of the Bar of the City of New York in the public hearing before the Commission who based his argument against repeal of the rule not on its legal validity or soundness but on the fact that it was an interpretation of long standing, the rescission of which would be unsettling to business and which therefore should not be rescinded except by Act of the Congress. I find here a startling recognition, *sub silentio*, of the underlying legal difficulty with the rule as it now stands. I believe that the least unsettling effect on business and the soundest approach by the Commission charged with administering the statute would be to face the problem squarely and provide appropriate registration forms and procedures for those transactions which the Securities Act by its terms and purpose requires to be registered.

In this connection, I would like to say that the Congress placed upon the Commission a great responsibility when it entrusted to it the duty to make available to the public the information necessary for the protection of the investors in all phases of the investment process —that is, in buying, holding for investment or selling securities.

Conclusion

In conclusion, let me say that good accounting, auditing and reporting is the cornerstone of financial integrity. The requirements of the Securities and Exchange Commission under the Federal securities laws with respect to accounting rules and independence have been of immense value to the profession, to industry and to the investing public. In 1936 the Commission said, ". . . The insistence of the Act [Securities Act of 1933] on a certification by an 'independent' accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedures and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities . . ."[36] Time and again we have reiterated this view and it is as true today as it was two decades ago. The enormous amounts of capital which American industry must raise in the securities markets in the years ahead cannot possibly be raised if the investing public does not have confidence in the integrity of the capital markets. Confidence in the integrity of the markets depends on the maintenance and continued improvement of American accounting and auditing standards.

References

1. Form X-17A-5.
2. Rule X-17A-5.
3. Earle C. King, who has since resigned from the Commission's staff.
4. Schedule A, paragraphs 25 and 26.
5. Section 7.
6. Instruction 13, Form S-1.
7. Sections 12 and 13.
8. Sections 8 and 30.
9. Section 15(d).
10. Section 13.
11. See prospectuses for "A.K.U.", December 2, 1953; Simca, April 30, 1956; KLM Royal Dutch Airlines, May 1, 1957.
12. The "A.K.U." Prospectus, Journal of Accountancy, April 1954, p. 483.

13. Form S-1.
14. Securities Act Release 3735, December 21, 1956.
15. *In the Matter of McKesson & Robbins, Inc.—Summary of Findings and Conclusions,* Accounting Series Release No. 19, Dec. 5, 1940.
16. Securities Act Release No. 3782, April 30, 1957.
17. Regulation S-X - Form and Content of Financial Statements.
18. Rule N-7D-1, Item (b) (8) (G).
19. Report of the Securities and Exchange Commission on S. 2054 (84th Congress) to the Committee on Banking and Currency of the United States Senate, Committee Print of May 25, 1956.
20. Hearing before the Committee on Banking and Currency, United States Senate, 84th Congress, 2d Sess. on S. 2054, June 22, 1956. Part 2-A, pp. 1270-71, 1283.
21. Supplementary Report of the Securities and Exchange Commission on S. 2054 (84th Congress) of the Committee on Banking and Currency of the United States Senate, Committee Print Feb. 11, 1957.
22. Regulation S-X.
23. A fuller discussion of the problems in connection with insurance company reports and the Fulbright Bill may be found in my article entitled "Insurance Company Reports to Stockholders," which will appear in an early issue of *The Spectator*, the media for insurance marketing and management.

23a. Senate Report No. 700, 85th Congress, 1st Session, July 24, 1957.

24. Rule 133 under the Securities Act.
25. The "no sale" theory was expressed as a footnote to Form E-1 under the Securities Act from 1935 to 1947, when it was rescinded. It continued to be followed as an administrative policy until 1951, when it was adopted as a Commission rule (Securities Act Release 3420, Aug. 2, 1951).
26. Securities Exchange Act Release No. 5483, (April 8, 1957).
27. In the case of *SEC* v. *Micro-Moisture Controls Inc.* the United States District Court for the Southern District of New York, when faced with a somewhat similar set of circumstances, concluded that Rule 133 is not applicable to an exchange of assets for stock which is "but a step in the major activity of selling the stock." (CCH Fed. Securities Law Service, Par. 90, 804 (1957).)
28. Compare the interpretive rules frequently issued by the Commissioner of Internal Revenue pursuant to Section 805 of the Internal Revenue Code, rule-making provisions of which are no broader in this regard than Section 19(a) of the Securities Act. The authority of the Commissioner to adopt such rules has been upheld by the Supreme Court. (See *Morrissey* v. *Commissioner*, 296 U. S. 344 (1935) and *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90 (1939).)
29. Rule 133 might also be regarded as an exercise of the Commission's power to define accounting, technical and trade terms. It is arguable, however, that the term "sale", which is one of the basic legal terms clearly defined in Section 2(3) of the Act, does not fall into the category of an accounting, technical or trade term.
30. Section 2(3) of the Securities Act.
31. Section 17.
32. Section 3(a).
33. H. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 16 states in part: ". . . This paragraph (Sec. 3(a) (10)) also exempts the distribution of securities during a bona fide reorganization of a corporation when such reorganization is carried on under the supervision of a court. Reorganizations carried out without such judicial supervision possess all the dangers implicit in the issuance of new securities and are, therefore, not exempt from the Act. For the same reason the provision is not broad enough to include mergers or consolidations of corporations entered into without judicial supervision."
34. Section 3(b) of the Securities Act.
35. *National Supply Co.* v. *Leland Stanford, Jr., University*, 134 F. 2(d) 689 (9th Cir., 1943).
36. *In the Matter of Cornucopia Gold Mines*, 1 S. E. C. 364, 367 (1936).

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Real Estate Corporations—Penalties . . . Unincorporated Business Tax—Independent Agents . . . Income from Partnerships.

Real Estate Corporations—Penalties

The franchise tax return is due by March 1. An extension of time for filing the return will usually be granted on condition that a tentative report is filed on or before the due date accompanied by the full amount of tax due.

Our attention has been called to several cases where a tentative report was filed accompanied by a payment of $10.00, the minimum amount of tax due. In each case a penalty of 5% plus 1% a month was assessed against the corporation on the difference between the tax finally shown to be due and the estimated tax of $10.00 submitted with the tentative return.

When the Corporation Tax Bureau was asked why the penalty had been assessed it replied that it was for failing to submit the proper remittance at the time of filing the tentative report. In one case the Bureau noted that the tax finally paid was approximately the same as for the previous year, implying that the corporation should have known that the final tax would exceed the amount remitted with the tentative return.

BENJAMIN HARROW, C.P.A. *and member of the New York Bar, has been a member of our Society since 1928. Formerly a Professor of Law at St. John's University, Mr. Harrow is a past vice-president of our Society. The committees of his present or past service, as member or chairman, include Federal Taxation, New York State Taxation and Estate Planning. He is engaged in practice in New York City.*

Unincorporated Business Tax—Independent Agents

One of our members asks our opinion as to the taxability under the unincorporated business tax of a salesman under the following circumstances. The salesman is employed by a corporation on a commission basis. He is neither a stockholder nor an officer of the corporation. The corporation withholds from the salesman's commission, social security taxes and income taxes. The salesman employs two individuals who help him and they are paid by the salesman out of the commissions he receives. They have no employee status with the corporation.

As an employee, an individual is not deemed engaged in an unincorporated business with respect to his compensation for services as an employee and the law specifically so provides (Section 386). But an independent agent may be carrying on an unincorporated business. The independent operation of an office and the method to be used by the agent in securing business will determine the agent's taxability under the unincorporated business income tax.

One test is whether the agent is accountable to the employer both as to the method in which his affairs are carried on and the results obtained. If the employer controls the agent with respect to the method, and if the employee performs his services in an office maintained entirely by the employer, the employee is not an independent agent taxable under the unincorporated business tax. The employment of assistants is usually a test of carrying on an unincorporated business. All these factors are weighed by the Commission to determine whether the taxpayer is an independent agent subject to the tax or merely an employee not subject to the tax.

The same issue with the facts a little different was also submitted to us in another case. This was the case of a salesman who carried three different lines of three different manufacturers. The salesman operated from his home. He did have the assistance of a porter who carried his samples. No social security or income taxes were withheld from his compensation, which was on a commission basis. In 1953 the law was amended and now provides that an individual is not subject to the unincorporated business tax merely because he is employed by more than one employer.

The tests to determine whether a taxpayer is an independent agent would apply in this case just as they would in the previous case. If this salesman is controlled by the employers as to the methods of operation and the results, he is not an independent agent and the compensation received by him would be exempt from the unincorporated business tax. In this case the employers apparently consider the taxpayer an independent agent. He maintains an office in his home and employs an assistant. The Tax Commission would probably subject the income to the unincorporated business tax.

Income from Partnerships

Before 1954, under the federal law, the method of taxing income from partnerships made it possible for more than a year's income to be taxed in the final return of a decedent. It was then held that the death of a partner terminated the partnership and, as a result, the final return of a decedent partner could include as much as twenty-three months of partnership income. That would be the case where the partner reported on a calendar-year basis, the partnership on the basis of a fiscal year ending January 31, and the partner died at the end of December. The decedent's final return would include the partnership income for the twelve months ending January 31, and, in addition, the eleven-month period from February 1 to the date of death. To remedy this situation, the Internal Revenue Code of 1954 provides (Section 706(c)(2)) that the taxable year of a partnership with respect to a partner who dies shall not close prior to the end of the partnership's taxable year. In the above example, the decedent's return will now include the share of partnership income for the fiscal year ending January 31, while the share of partnership income for the period from February 1 to the date of death will be taxable to the estate.

The Code also provides that with respect to a partner who sells or exchanges his entire interest in a partnership, or whose interest is liquidated, the taxable year of the partnership shall close. In these cases, more than twelve months of partnership income may be concentrated in one return of the partner.

Effective July 1, 1957, the New York law has been changed to follow the Federal law (Section 364, as amended by L. 1957, c 372). Prior to the recent change the partnership's fiscal year continued in all cases.

Accounting at the SEC

Conducted by Louis H. Rappaport, C.P.A.

Transactions and Events Subsequent to the Statement Date

One of the most troublesome aspects of a public accountant's practice is the disclosure of events and transactions subsequent to the date of financial statements upon which he is reporting. An authoritative statement [1] on the subject was issued in 1954 by the AICPA Committee on Auditing Procedure. The Committee pointed out that events or transactions, either extraordinary in character or of unusual importance, sometimes occur subsequent to the balance sheet date which may have a material effect on the financial statements or which may be important in connection with consideration of the statements. Such events or transactions may require adjustment or annotation of the statements. Financial statements are not prepared in a vacuum, and if they are to serve a useful purpose, no one can argue with the foregoing generalizations. The question for the practitioner to answer is how far he should go to see whether such an event or transaction has occurred.

Louis H. Rappaport, C.P.A., *a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.s, is the author of* SEC Accounting Practice and Procedure.

Applicable Auditing Procedures

The Institute Committee stated its opinion that the auditor has no duty to extend the usual audit procedures to cover transactions of the subsequent period, as such, but it recognized that a well-conceived audit program relating to the period under examination will include:

(a) Certain steps which ordinarily are carried out after the balance sheet date (such as cash cut-offs, review of subsequent collections, and confirmation follow-ups) and

(b) Certain general procedures which are designed to support an informed opinion on the financial statements (such as reading available minutes and interim reports, and discussions with management) which normally are continued throughout the auditor's examination.

Types of Post-Balance Sheet Events

The Institute Committee recognized three types of post-balance sheet events or transactions:

1. Events of the first type directly affect the financial statements and should be recognized therein. Thus, if subsequent information is acquired in time to permit its use, if the information provides a basis for more accurate estimates or provisions, and if the information would have been used had it

1. Statements on Auditing Procedure, No. 25 (Oct., 1954).

been available at the balance sheet date, appropriate adjustments should be made in the statements.

2. Events of the second type have no direct effect on the statements and therefore do not require adjustment of the financial statements of prior periods, but their effects may be such that disclosure is advisable. Examples are serious damage from fire or flood, or large capital issues.

3. Events of the third type include non-accounting events such as war, management changes, loss of important customers, product changes, and strikes. Disclosure of such events frequently creates doubt as to the reason therefor, and inferences drawn could be misleading as often as they are informative.

The Committee believes that disclosure should be confined to those matters essential to proper interpretation of the financial statements.

SEC Pronouncements

The foregoing Institute bulletin is a relatively recent one. Prior to its issuance in 1954 the SEC expressed itself in a number of cases on the question of disclosure of events and transactions subsequent to the statement date.

In *Potrero Sugar Company* [2] the Commission held that a financial statement was not misleading for failing to disclose subsequent cost increases in connection with settlement of a strike. Substantially the same issue was discussed in *Central Specialty Company* [3]

In *Oklahoma Hotel Building Company* [4] the registrant had defaulted in the payment of interest after the date of the balance sheet but before the date of the accountant's certificate. The SEC held that the failure to disclose the default was a material omission. The duty to disclose the default, said the SEC, rested both on accepted accounting standards and on the requirements of full disclosure under the Securities Act.

Colorado Milling and Elevator Company [5] dealt with extraordinary transactions and events before and after the statement date.

Adjustment of Accounts vs. Footnote Disclosure

In March, 1951, a utility company filed its registration statement for an offer of common stock. The income statements for 1949 and 1950 included approximately $125,000 and $415,000 ($75,000 and $228,000 after taxes), respectively, and the balance sheet included a deferred credit for contingent revenues of approximately $412,000 (equivalent to $227,000 after taxes) for revenues billed by the registrant pursuant to a rate increase granted by the local regulatory commission. At the time of filing the United States Court of Appeals had affirmed the action of the United States District Court in vacating the regulatory commission's order and had ordered amounts collected after a certain date impounded. The Court had ordered that the registrant refund to its customers all monies collected under the increased rates but had granted a stay of its judgment pending appeal to the Supreme Court. The above situation was fully disclosed in the financial statements, and matters requiring amendment had been corrected to put the statement in final form. However, at about the time the registration statement was to become effective, the Supreme Court refused to review the Appellate Court's findings that the order

2. 5 SEC 982 (1939).
3. 10 SEC 1102 (1942).
4. 4 SEC 584 (1939).
5. 15 SEC 20 (1943).

of the local regulatory commission be vacated. The registrant and its accountants then proposed to expand the footnote describing the litigation to explain the effect of the Supreme Court's action but without eliminating from the income statements the revenues then to be refunded or correcting the balance sheet to show the liability for the ordered refund. The registrant was requested by the SEC's staff, however, to adjust the income statements and balance sheet in respect of the refundable amounts, since under the circumstances no accounting justification then existed for including in the income statements amounts which clearly were not proper revenue items and for failing to show the proper current liabilities. The statements were amended as requested by the SEC.[6]

A registrant engaged in the liquor business included in its annual report to the SEC, as a note to the financial statements, a disclosure that, within the month subsequent to the balance sheet date, settlement in a substantial amount had been made in respect of claims against it relating to its sale several years before of investments in certain companies. The accountants' opinion covering the financial statement was signed approximately seven weeks after the settlement date. On the basis that the accountants had knowledge of the final status of the claims prior to the signing of their opinion, the Division of Corporation Finance requested and obtained the filing of revised financial statements reflecting the settlement.[7]

The preceding paragraph relates to an annual report filed with SEC. Presumably the point involved would be even more applicable in the case of a filing of a registration statement.

Method of Disclosure of Subsequent Events

As a part of their examination, public accountants are concerned with events and transactions subsequent to the date of the financial statements they certify. While many accountants incorporate such events and transactions in the statements or the footnotes, other accountants go to great lengths to distinguish between those events and transactions occurring between the date of the balance sheet and the date of their certificate, and those subsequent to the date of their certificate. The following note appearing in the financial statements in a prospectus filed with SEC shows how one accountant disclosed events and transactions subsequent to the statement date.

NOTE 15. EVENTS SUBSEQUENT TO DECEMBER 31, 19 :

TO DATE OF OPINION OF INDEPENDENT PUBLIC ACCOUNTANTS FEBRUARY 23, 19

The Corporation acquired on January 3, 19 , pursuant to an exchange offer agreement of November 23, 19 , certain shares of preferred and common stocks of (Company A) by the issuance of shares of a new series of Cumulative Preferred Stock, entitled $5 Dividend Series B 19 having a stated value of $100 per share, and shares of Common Stock. Subsequent to consummation of said agreement, or on or about January 26, 19 , additional shares of (Company A) common stock were acquired by a cash payment of $, so that at February 23, 19 the minority interest in (Company A) amounted to approximately %. (See comment (i) below.)

On February 23, 19 , an exchange offer agreement was entered into with the stockholders and certain noteholders of (Company B) by which the Corporation would acquire (a) all of the outstanding stock of that com-

6. 17 SEC Ann. Rep. 16 (1951).

7. 18 SEC Ann. Rep. 33 (1952).

pany by the subsequent issuance of shares of Common Stock, and (b) $ principal amount of the 4% promissory notes of that company by the subsequent issuance of shares of a new series of Cumulative Preferred stock, entitled $3 Dividend Series A 19 , having a stated value of $100 per share. (See comment (ii) below.)

AFTER DATE OF OPINION OF INDEPENDENT PUBLIC ACCOUNTANTS

(i) After February 23, 19 and on or about March 3 and April 1, 19 , additional shares of preferred stock and common stock of (Company A) were acquired by the Corporation, resulting in the issuance by the Corporation of shares of Cumulative Preferred Stock, $5 Dividend Series B 19 and shares of Common Stock. The aggregate value of the investment of the Corporation in (Company A), as determined by the Board of Directors for all shares of stock of the Corporation issued and cash paid, amounted to $.

(ii) The issuance and delivery of (a) the shares of Common Stock in exchange for all of the outstanding stock of (Company B) and (b) the shares of Cumulative Preferred Stock, $5 Dividend Series A 19 , having a stated value of $100 per share, in exchange for the above mentioned promissory notes of said company was made on March 7, 19 . The aggregate value of this investment and the notes receivable acquired, as determined by the Board of Directors of the Corporation for shares of stock issued, was $.

(iii) At the annual stockholders meeting on April 26, 19 , the stockholders approved:

(a) An increase in the authorized number of shares of Preferred Stock, without par value, from to .

(b) The stock option agreements, dated December 29, 19 (referred to in the last paragraph of Note above.)

(c) The employees stock option or purchase plan previously approved by the stockholders in 19 under which additional stock options may be granted.

(iv) The exchange was made on April 28, 19 of the remaining retained shares of (Company C) (referred to in the second paragraph of Note above) by the issuance of shares of Common Stock of the Corporation.

(v) Events subsequent to February 23, 19 referred to in various sections of the Prospectus:

(a) Offer to stockholders of various series of outstanding Preferred Stocks to exchange such Stocks for shares of a new series of Cumulative Preferred Stock, the expected redemption of remaining Preferred Stocks not exchanged, and the borrowing restrictions effected by, and the sinking fund benefits of, the new series—refer to "Exchange Offer" and "Description of Preferred Stock" in the Prospectus.

(b) Arrangements for new long-term borrowing by the Corporation involving further or different restrictions from those described in Note above on dividends and other distributions on and purchases and other acquisitions of capital stock and certain investments —refer to "Purpose of Financing", and "Dividend Rights and Restrictions" under "Description of Preferred Stock" in the Prospectus.

Dating of Certificate

Other accountants believe that there is little to be said in favor of classifying footnote information along the lines indicated in the preceding example. These accountants believe that, since the financial statements are management's representations, the information in footnotes should be in the form that would be used by management, and, accordingly, there should be no distinction as to events and transactions which occurred before or after the date of the accountants' report.

These accountants prefer to retain as the date of their report the date on which they originally formed their opinion on the financial statements. They

may be troubled, however, by the fact that while the report is dated, say February 15, the information in the footnotes may speak as of a later date, say April 10. They overcome this difficulty by dating their certificate in the registration statement as follows: "February 15, 19 except as to the matter referred to in Note of the Notes to Financial Statements as to which the date is April 10, 19 ." It seems to this writer that some accountants are needlessly disturbed by this apparent conflict of dates. In view of the necessity of keeping in touch with the financial affairs of the client after the filing date, the writer would not hesitate, in the ordinary case, to up-date the certificate.

College Preparation

In spite of the fact that a very large number of graduates do not pass the [CPA] examination on their first attempt, some graduates are able to pass and to do so with high marks. The number of these varies widely from school to school. This difference in performance is found also in the performance of college students on the objective tests developed by the Institute's Committee on Accounting Personnel. Studies of results on these tests show that even the poorest student in some schools performed better than the average student in other schools, and that the variation between schools is extremely wide.

It is not too surprising that at the present time a large number of college graduates who have majored in accounting not only fail to pass the CPA examination on their first attempt, but make very low grades. This indicates that the minimum standard for graduation is below that of the examination. . . .

There is one feature about which there seems little doubt. Most of the colleges are attempting to do a dual job, if not a triple job. First, they are offering accounting as general service courses to all students in business administration. Also, many individuals take a major in accounting who do not expect to enter any field of accounting. Second, colleges are attempting to train individuals who expect to enter private accounting, governmental accounting and public accounting; usually using the same instructional methods and curricula for all groups. While this may be entirely feasible and may be the best possible method, present evidence of performance on the CPA examination raises a serious doubt as to the effectiveness of this general mixture of students and objectives. Third, the colleges are attempting, and perhaps quite properly, to give their graduates a broad training in business administration. They, therefore, restrict the amount of accounting which can be taken in the undergraduate program. . . .

Possibly another explanation of the wide disparity between the level of knowledge and ability of many college graduates and the requirements of the CPA examination is to be found in the sequence and emphasis of courses. In the area of auditing, a number of schools offer a one semester course which probably is not on a level comparable with the responsibility assumed by a man who is holding himself out as an independent practitioner. Income taxation may be in the same position in many schools, since only one course is offered. That amount of instruction probably is inadequate as training for the practitioner who must have a reasonable knowledge of taxation.

INFORMATION FOR CPA CANDIDATES, AICPA, 1954

Administration of a CPA Practice

Conducted by Max Block, C.P.A.

Relieving the Overburdened Practitioner . . . Gift Tax Files . . . Tax Return Review and Annual Report Review . . . Practitioners' Disability Policies . . . Eliminate the title "Balance Sheet"?

Relieving the Overburdened Practitioner

The following items comprise the first group of practical aids received in response to our request for ideas on relieving the overburdened practitioner.

Review of workpapers and reports. A major portion of this work can be done by a trained staff member, thereby leaving to partners a minimum of review. "A young CPA with a good theoretical background can be developed in two years or so to provide much assistance with the partner's supervisory and review duties. The use of one reviewer assisting two or three partners will also result in greater uniformity in the firm's reports, workpapers, etc."

Editor's Note. Partners' supervisory responsibility cannot be delegated entirely. The Interstate Hosiery Mills matter of about ten years ago highlighted this point.

Extended use of the telephone. ". . . consideration should be given to the use of the telephone, wherever possible, as a substitute for personal visits. Some personal visits and conferences must, of course, be held. However, if the telephone is used every second or third time, a considerable saving in travel and other time will result without a loss of personal client relationship."

Editor's Note. If you get clients to call at your office you also save travel time. This arrangement has psychological advantages for the accountant. Further, conference time can be reduced if excessive and unnecessary talk is eliminated or minimized.

Use of handwritten duplicate memo forms. A carbonized duplicate form should be utilized for pencil written memos to other partners and staff, instead of dictating them, or writing only one copy. The partner keeps the carbon copy on his desk as a follow-up and reply reminder.

Editor's Note. Standard duplicate carbonized forms, in pads, can be purchased. Some of the printed forms provide space for a reply when that is required.

Other "burden relievers" will be published as received. Contributions from practitioners will be very welcome.

Gift Tax Files

Income tax files have been written up but very little has been done about gift

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tax files. Yet, gift tax files must be preserved for a lifetime whereas most income tax data has a relatively short-life term.

A separate file should be maintained for gift tax returns. Therein should be kept copies of the donor's return and of the related donees' returns. In addition a lifetime summary schedule should be maintained which will disclose at a glance, as a minimum, the exemption status of each spouse, adjusted as necessary to reflect tax examination changes. The file should also include all data necessary to support the valuations placed on the gifts, for examination purposes, and copies of Treasury Department reports. If obtainable, a record of the cost basis of each gift should be attached to the pertinent return because such data is required by the donee for tax purposes in the event of sale or exchange and, in some cases, if worthlessness develops.

Tax Return Review and Annual Report Review

Annual financial statements are not final until the pertinent income tax returns are reviewed and, conversely, the review of tax returns require reference to the annual report. This is necessary to insure the correctness of the income tax accrual. The two reviews in many instances are not made by the same person. Which should be done first and how does one reviewer communicate to the other that he has completed his review?

No doubt, many diverse procedures are in use, none of which is most satisfactory at all times, yet most of them are probably practical and reasonably satisfactory. One system in use involves a form which is filled out by the tax reviewer and attached to the report draft indicating that the income tax provision on the balance sheet and the income statement is satisfactory. In this instance, obviously, the tax reviewer gets the report and work papers first.

Descriptions of other procedures used are solicited and will be published.

Practitioners' Disability Policies

In Revenue Ruling 55-264, CB1955-1, 11, the Treasury ruled that premiums paid for policies reimbursing a professional man for overhead expenses while he's disabled are deductible but the proceeds of such insurance constitute taxable income. The idea of taking out a disability policy to recoup overhead is perhaps strange to practitioners and not sufficiently advertised by insurance companies. Whether the proceeds are used for office overhead, or to pay for medical and other costs, does not particularly matter as a general rule, though non-overhead proceeds are tax free.

Practitioners who would like the tax deduction each year and speculate on the tax on the proceeds should inquire about "Fixed Expense Disability Policy" or "Overhead Expense Disability Policy" or "Business Expense Disability Policy", all of which accomplish the same objective.

Eliminate the Title "Balance Sheet"?

Accounting Trends and Techniques (AICPA), published in October 1957, discloses that an increasing number of listed companies discarded the title "Balance Sheet," which conveys no meaning to the laity, and replaced it with "Financial Position" or "Financial Condition." The new terms are certainly more meaningful, despite limitations therein that might be pointed out, and the change is recommended to all practitioners for early implementation.

If the phrase "as of the close of business on" were placed before the date it would highlight the fact that the data is as of a certain moment, thereby conveying more adequately the idea that the statement has a transitory nature. Comments on this aspect will be welcome.

Payroll Tax Notes

Conducted by Samuel S. Ress

Unemployment Insurance Experience Rating

The question arises among practitioners as to what can be done to cut an employer's unemployment insurance tax rate or to prevent unnecessary increases.

The New York State Unemployment Insurance Law provides for reduced tax rates for qualified employers. For the year 1957 the rates range from 0.8 per cent to 3.0 per cent of taxable payroll. It is contemplated that the rates for next year will have a similar range. Newly liable employers are required to pay at the rate of 2.7 per cent until they become qualified to participate in experience rating.

A "qualified employer" is one who has been covered by the law for 5 calendar quarters immediately preceding the "computation date"—July 1—of any year, and, on or before September 30th following the computation date, must have filed all contribution reports due for all calendar quarters immediately preceding such computation date. In addition the employer must have paid some remuneration to employees in the fiscal year immediately preceding the computation date. The fiscal year is the period beginning July 1, 1956 and ending June 30, 1957 for employers entitled to experience rating for the calendar year beginning January 1, 1958.

An employer who has had any negative balance in his individual employer's account resulting from benefit charges exceeding contribution credits (transferred as a charge to the general account established under the provisions of the law, within the 12 consecutive calendar quarters immediately preceding the computation date), is assigned the maximum rate for a three-year period regardless of how small the negative balance may have been. Any employer who had a negative balance in his unemployment insurance individual account during any calendar quarter during the period July 1, 1956 through June 30, 1957, will be required to pay unemployment insurance taxes at the 2.7 maximum rate on his payrolls for the years 1958, 1959 and 1960, plus whatever rate is imposed upon all employers for subsidiary contributions to the fund, amounting to 0.3 per cent for 1957.

It is expected that there will be a similar subsidiary contribution assessment for the year 1958. The subsidiary contribution paid by an employer is credited to the general account and not to the individual employer's account. The result of this procedure is that an employer cannot get credit for rate reduction or for preventing an overdraft it is excessive. Appropriate action can against his individual account where

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Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of its Subcommittee on Unemployment Insurance.

benefit charges exceed credits for contributions at experience rates. For example, an employer whose experience rating entitles him to a 2.1 per cent tax rate for 1957 plus the 0.3 per cent subsidiary contribution on a $100,000 taxable payroll, remits $2,400 to the unemployment insurance fund; only $2,100 will be credited to his individual account and $300 will be credited to the general account. Even though a negative balance could have been prevented by giving the employer full credit, for experience rating purposes, of the actual $2,400 payment, the employer will be required to pay contributions at maximum rates for the following three-year period. It appears that this inequitable situation should be corrected by an amendment to the law which will give employers experience rating credit for subsidiary contributions paid.

An employer's experience rate is derived from four factors which, added together, make up the employer's experience factor. The employer's benefit factor, and his quarterly, annual and age factors are all subject to various degrees of control which when properly exercised will result in the lowest possible experience rate. Establishment of joint accounts may be advisable.

The weightiest of the four factors is the benefit factor, from which from 0 to 16 points may be obtained. Each of the other factors provides from 0 to 2 points. The installation of an appropriate tax rate control system is directed at establishing records and procedures designed to get the maximum number of points for each of the factors with special emphasis on the benefit factor.

Payroll tax rate controls require special treatment. The checking and review of the unemployment insurance rate assigned to an employer may show that it is excessive. Appropriate action can be taken to have it reduced. Under an amendment to the law which became effective July 1, 1956, corrections and modifications of an employer's payroll, remuneration paid by him, experience rating charges made to his account, or any other factor which affects his experience factor, may be taken into account for the purpose of having his experience rate redetermined before the expiration of two years following the effective date. That means that rates erroneously computed for the year 1957 may be corrected prior to January 1, 1959, even though the result would be a reduction in rate.

A benefit control system to prevent improper benefit charges to the individual employer account should be established. Checking and follow-up of former employee unemployment insurance claims and benefit payments are required in order to determine whether or not they are being paid in accordance with the law. The weekly benefit charge statement submitted by the State to the employer should be checked regularly and analyzed in order to determine whether the benefit payments have been properly charged to the employer's account. From that statement it may also be determined whether or not certain benefit claimants who may have been entitled to benefits originally, may now be found ineligible because of a withdrawal from the labor market or for some of the many other reasons set forth in the law. In order to continue collecting benefits lawfully, the recipient is required to show that he continues readv. able, willing to work and is actively seeking suitable employment for which he is fitted by reason of his training and experience, after taking into consideration current labor market conditions and those types of employment set forth in the law which he may refuse, if offered to him.

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Insurance on Lives of Stockholders . . . Travel Expenses . . . Distribution for Sales Price of Stock . . . Amortization of a Leasehold . . . Notes Receivable: Payment or Evidence of Indebtedness . . . Non-Deductible Corporation Expenditures Taxed to Sole Stockholder . . . An Inactive Business Cannot Give Rise to a Net Operating Loss Deduction . . . Timeliness of Claim for Refund.

Insurance on Lives of Stockholders

In what may turn out to be a leading case, the Court of Appeals for the Second Circuit reversed the Tax Court in the case of *Oreste Casale*, which had held that the 98-percent stockholder was chargeable with a dividend by reason of the corporate payment of a premium on a combination life insurance-annuity policy issued on the individual's life.

The Second Circuit emphasized the pivotal fact that the policy constituted a corporate asset in every sense of the word (the Tax Court having found as a fact that the corporation possessed all of the incidents of ownership in the policy and was the sole beneficiary thereof). In the event of insolvency, the Court pointed out, corporate creditors would be able to reach the policy as they might any other asset. It stated that the taxpayer-stockholder would at most have an unsecured claim under his deferred-compensation contract, which the policy was intended to fund, and would share prorata in, or might even be subordinated to, the claims of other creditors.

In concluding his opinion, Judge Hincks stated that no case or legislative provision had been brought to the Court's attention in support of the Commissioner's contention that the entity of a corporation actively engaged in business might be disregarded for tax purposes merely because it is wholly owned or controlled by a single person. (*Oreste Casale* v. *Com.* CA-2, 9/5/57)

There is still on appeal to the First Circuit the case of *Henry E. Prunier* (28 TC—No. 4, 1957) which was previously reported (NYCPA Vol. XXVII No. 6, page 425). To the extent that the Tax Court's decision in that case rests upon its holding in the *Casale* case, it would appear to be untenable. In

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RICHARD S. HELSTEIN, C.P.A., *has been a member of our Society since 1940. He has been a member of the Committee on Federal Taxation, as well as various other committees. He is presently a member of the Committee on Publications.*

Mr. Helstein has contributed to accounting and other publications, and delivered addresses before our Society and other professional societies. He is associated with J. K. Lasser & Co.

Prunier, however, the corporation was neither the beneficiary nor the owner of the policies, so that the principal arguments of the Court of Appeals in *Casale* would probably not be pertinent to *Prunier*.

In any event, the opinion of the Court of Appeals in the *Casale* case should enable closely-held corporations to avail themselves of life insurance for funding deferred-compensation agreements or arrangements for the redemption of a deceased stockholder's interest, without encountering any adverse income tax consequences by reason of corporate premium payments. However, in order to come within the scope of the *Casale* decision the corporation should be named the beneficiary of the policy and should be vested with all of the incidents of ownership therein.

Travel Expenses

Where a taxpayer receives a flat mileage allowance from his employer for the use of his own automobile in business, that allowance is presumed to cover reimbursement for that portion of the depreciation of the car which is applicable to business use.

Thus, where a taxpayer received such an allowance, reported it as gross income, and deducted the exact amount as travel expense, he was not entitled to an additional depreciation allowance unless he could prove either that the allowance did *not* cover depreciation, or that his travel expenses plus depreciation *exceeded* the allowance. (*Walter I. Geer* 28 TC—No. 112).

It would appear most important, particularly in view of the present Treasury policy in connection with "business expenses," that in any case of flat allowances, whether for travel or for any other business expense, the employer clearly define what such allowance is to cover.

Distribution for Sales Price of Stock

The taxpayers, husband and wife, sold, as at April 30, 1943, all of the stock in a corporation jointly owned by them under the community property laws of Louisiana. The price was the net worth of the business on that date, as set forth on a statement of a certified public accountant. The price was determined on May 28, 1943 in accordance with the accountant's work sheets, and a formal report was submitted June 1, 1943. From April 30 on, the purchasers were in control of the business although the sellers retained ownership of the stock until June 30, 1943.

After April 30, a check of the corporation was issued to the sellers, and subsequently certain assets of the corporation including U.S. Bonds, listed stock and certain accounts and notes receivable were transferred to the sellers. These receipts were treated as payments on account of the sales price of the stock.

The Service maintained that these receipts were dividends and the District Court agreed. However, the Fifth Circuit Court of Appeals reverses. The purchasers were the beneficial owners of the stock from April 30, 1943, and if a dividend had been distributed after that date, it would have accrued to the purchasers. Since ownership of the assets vested in the purchasers on April 30, the transfer of the assets was merely made in lieu of paying their value to the sellers. (*Mayer* v. *Donnelly*, CA-5, 8/13/57).

Amortization of a Leasehold

Where a taxpayer acquired a leasehold on property, including a building for 99 years, with options to terminate at the end of 25, 50 and 75 years, the leasehold must be written off over the full 99 year period.

Even though the building had a life expectancy of less than 99 years, the Tax Court held that the taxpayer had no depreciable interest in the building as such, since it was not erected by the lessee.

Neither are the options to terminate controlling in determining a shorter period over which to amortize the leasehold (*David Dab* 28 TC—103).

Notes Receivable: Payment or Evidence of Indebtedness

The taxpayer received an unsecured, non-interest bearing note from a maker, who was without funds at the time of issuance, in return for services performed. The taxpayer attempted but was unable to sell the note.

The note did not constitute income in the year received because it was not issued in *payment* of indebtedness, but as *evidence* of it. And even if it had been issued in "payment", it had zero fair market value. (*Jay W. Williams* 28 TC—No. 114).

Non-Deductible Corporation Expenditures Taxed to Sole Stockholder

Where the Tax Court found that the activities of a wholly-owned corporation did not constitute the carrying on of a trade or business, but were attributable to the personal hobby of the sole stockholder, the expenditures involved were not only disallowed as deductions to the corporation, but were also taxed as dividends to the sole stockholder (*American Properties, Inc.* 28 TC No. 127).

An Inactive Business Cannot Give Rise to a Net Operating Loss Deduction

Where a taxpayer merely maintained a place of business, paying rent and other expenses, holding and returning stock in trade previously acquired, but making no sales pending the obtaining of a license, the loss incurred was not "attributable to the operation of a trade or business regularly carried on by the taxpayer" (Sec. 122(d)(5) IRC 1939 and Sec. 172(d)(4) IRC 1954).

As a result, in the following years after a license was obtained and profits were made, the taxpayer was not entitled to a net operating loss deduction. (*T. E. Penton* v. *U.S.A.*, U.S.D.C. East. Dist. Tenn. 7/1/57).

The Court reasons that the expenses were not incurred during liquidation of the business (Cf. *Robert C. Duff* 23 BTA 1343 (1931) and since the business could not legally be operating without a license, the expenses were capital investment.

Timeliness of Claim for Refund

Where no return was filed on the due date, but more than three years after such date, a delinquent return was filed in an effort to recover taxes withheld and paid as estimated taxes, such return is an untimely claim for refund under both Sec. 322(b) IRC 1939 and Sec. 6511, IRC 1954 (Rev. Rul. 57-354, IRB 1957-31, 43).

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